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FROM THE CHAIR

Garth Jacobson
CT Corporation
Seattle, Washington

Greetings from the Chair,

As a shout out to Tom Rutledge’s many historical factoids and Bob Keatinge’s love of Shakespeare, I offer my own intro related to the play Julius Caesar.

Beware the Ides of March (March 15), or perhaps the Ides of March plus two... That is St. Patrick’s Day. The former date being fatal to Julius Caesar and the latter causing painful but not fatal hangovers to imbibers at Butte, Montana’s notorious St Patrick’s Day festivities. The latter I can say I witnessed as a college student during a spring break. But the Ides of September minus 2 fall that is “9-11” (note the ides of a month may be on the 13, 14th or 15th), may have the biggest impact upon the formation agents of LLCs. The reason being the events of 9-11 created terrorism hysteria that resulted in many of the Financial Action Task Force (FATF) recommendations enacted in “Patriot Act” which contained major amendments to the Bank Secrecy Act. Congress granted the Financial Crimes Enforcement Network (FinCEN) the authority to require financial institutions obtain the names of the beneficial owners of a business entity. Nearly 15 years after the enactment of the Patriot Act, new rules adopted by Treasury Department go into effect this spring, requiring financial institutions to obtain the names of the beneficial owners with a 25% or greater economic interest in a registered business entity. That translates to banks having to vet the names of the beneficial owners of an LLC before it can open a bank account or provide financing to it. It appears, in recent congressional hearings, that the financial institutions are willing to share the pain with the business formation agents and require extra duties associated with the process. They seem to support efforts to change the BSA and have it apply to more than themselves.

So once again as Sherlock Homes would say, or as Shakespeare scribed in Henry V Act III Scene I, “The game’s afoot.” Congress has 4 or 5 bills pending before it that would call for the disclosure of the “beneficial owners” of an LLC. House and Senate hearings discussed
the aims of these legislative proposals.

Corporate Transparency
S1454 BO State filing Whitehouse, Grassley
Corporate Transparency
S1717 BO State or BFA Wyman, Rubio
Corporate Transparency
HR 3089 BO State or BFA Maloney, King
Corporate Transparency
TBD BO Fed filing Pierce
Corporate Transparency
HR2219 Fin. Inst. matters Royce

Starting in 2007 through his 2015 retirement, each session Senator Leven introduced in anti-money laundering legislation to Congress. Subsequent legislation carries the components of that legislation in some form or another. Most notably the current pending legislation would require a registry of beneficial owners with the state filing offices (S1454, S1717 and HR3089), or the federal government (HR???, Pierce.) Likewise legislation would place business formation agents under the BSA with consequences including filing suspicious activity reports (SARs) Attorneys may be exempted but... Other legislation requires a study to determine what needs to be done. Of note, nothing seems to harmonize between the legislation with a workable definition of what is beneficial ownership. Having watched BO legislation for over a decade I can say that this Congress appears to have an appetite to do something that may affect the way we do business and represent our clients. But I might add we have done this fire drill many times before.

The Corporate Laws Committee approached our Committee with a request to review their draft whitepaper and comment on it as a way to redirect the ABA’s position. At present the official position of the ABA is to oppose all legislation that would impede upon the practice of law and impact the privacy of our business entity clients. The Corp Laws Committee BO Transparency Task Force seeks to open a new dialog between the ABA and Congress by taking a position that affords some compromise yet protects the major concerns of the business entity attorneys. This not-so-easy task request requires that we examine the proposal and make recommendation and suggestions.

In the past our knee jerk reaction to this legislation has been to say hell no we won’t support anything that causes us heartburn. But the question is are we being shut out of the legislative development process by sounding recalcitrant? The Corporate Laws Committee is trying to promote a new ABA position that protects the client confidentiality Rule 1.6 Model Rules of Professional Responsibility while finding a compromise position of granting law enforcement some access to the entities BO information. Please review the attached draft position (p. 38) and provide comments back to me or Eric Feldman. We will be meeting on Thursday of the ABA Business Law Section spring meeting at 3 pm with Eric Feldman as the subcommittee chair on Anti-Money Laundering.

The Business Law Section spring meeting is shaping up to be well worth your while for attending. We have three CLE programs:

- Bankruptcy Remote Entities - Are They Really? Thursday April 12, 1 – 3 pm
- LLC Case Law Update (The Beth and Lou show) 8 am Friday April 13

Our Committee dinner is at the Moonfish on Thursday evening and the Committee meeting is on Friday at 10 am after the Case Law Update CLE.

There are other events associated with our committee so check the agenda.

Finally we have finalized the date and location of the 2018 LLC Institute. It will be at the DC Westin on Oct 11 and 12. Unfortunately our former location is no longer available for meetings so we had to find a new location. We will need to adjust our attendance fee due to increased cost of the facility but it will still be a great deal for CLE credits and networking opportunities. If you have to pick one Committee event to attend this year I recommend the Institute over the other gatherings. It provides the best cost benefit of anything we do. I look forward to seeing you there.
Thursday, April 12, 2018

1:00 p.m. – 3:00 p.m.   Program (2 hrs.) Bankruptcy Remote Entities: Are They Really?  
(Panzacola H-1, Level 1)

2:30 p.m. – 4:00 p.m.   Program (1.5 hrs.) Multi-Member LLC Interest as Collateral and the New Model Form Security Agreement for Security Interests in LLC Membership Interest (Co-sponsored with Commercial Finance)  
(Panzacola H-3, Level 1)

3:00 p.m. – 4:00 p.m.   Anti-Money Laundering Subcommittee Meeting  
(Panzacola F-2, Level 1)

4:30 p.m. - 5:30 p.m.   International Use of US Business Entities Subcommittee Meeting  
(Suwannee 18, Level 2)

7:00 p.m. - ?   Dinner- MoonFish, 7525 W. Sand Lake Road, Orlando, FL 32819

Friday, April 13, 2018

8:00 a.m. - 10:00 a.m.   Program (2 hrs.) Case Law Update  
(Panzacola H-4, Level 1)

10:00 a.m. – 12:00 p.m.   LLCs, Partnerships and Unincorporated Entities Committee Meeting  
(Suwannee 15, Level 2)

11:30 a.m. – 12:30 p.m.   Security Interests in LLC and Other Unincorporated Entity Interests Task Force Joint Meeting  
(Panzacola F-3, Level 1)

Saturday, April 14, 2018

10:30 a.m. – 12:30 p.m.   Program (2 hrs.) Ethical Issues in LLC Formations and Maintenance: Who Is (and Isn’t) the Client? (Co-sponsored with Professional Responsibilities)  
(Panzacola H-3, Level 1)
Wrong Law Applied, Wrong Words Used, But the Correct Result Reached
Stockdale v. Ellsworth

By: Herrick K. Lidstone, Jr.  
Burns, Figa & Will, P.C.  
Greenwood Village, Colorado 

On December 18, 2017, the Colorado Supreme Court issued its opinion in Stockdale v. Ellsworth.1 This opinion discussed some of my favorite subjects — piercing the veil of a limited liability entity (in this case, a limited liability company) and tracking down missing heirs of a successful oil and gas property. It also included some interesting civil procedure conclusions, as well.

Title Searches and Missing Heirs

Stockdale was based on production from oil properties in La Plata County, Colorado, owned of record by Roy P. Cardwell, deceased, who obtained record title to his mineral interest in 1938. Because Cardwell and his heirs could not be located in the 1990s when the Colorado Oil and Gas Conservation Commission authorized the pooling of interests in the area, the proceeds attributable to Cardwell’s interest were held in suspense as the natural gas wells were developed. When XTO filed the interpleader action in 2009, the proceeds attributable to Cardwell’s interest totaled approximately $2.7 million, and it was growing due to continuing production. That’s real money in most people’s opinion.

Chester J. Ellsworth had identified potential heirs of a Mr. Cardwell who died in California in 1971 (the “California heirs”) and acquired a mineral deed from them based on representations that the properties in La Plata county were valueless because there was no oil and gas production and in fact there may be no minerals on the property. According to the Court, “Ellsworth also falsely warned the California heirs that they could be liable for any costs of production or accidents associated with their interests.” Ellsworth made these misrepresentations to the California heirs even though (in the Court’s words) “Ellsworth (or entities he controlled) had already received over $1 million in proceeds from mineral interests in adjoining lands.”

In researching the interpleader action, XTO also identified heirs of a Roy P. Cardwell who died in Kansas in 1980 (the “Kansas heirs”), as well as two business entities managed by Ellsworth – CEMPCO, Inc. (a Colorado corporation formed in 1978) and Seawatch Royalty Partners, LLC (a Wyoming manager-managed LLC formed in 2009 and qualified to do business in Colorado). Before trial, the Kansas heirs and CEMPCO withdrew their claims, leaving the battle for rightful ownership between the California heirs and the grantee of the mineral deeds, Seawatch. Ellsworth, individually, was not a party to this action.

After a seven-day bench trial, La Plata County Judge Dickinson issued his findings, order, and judgment on November 11, 2011. In the judgment, the trial court:

1. Granted the California heirs’ claims for rescission of the mineral deeds and assignments, concluding that Ellsworth (on behalf of Seawatch) had obtained the deeds and assignments by fraud and misrepresentation.

2. Found that “Seawatch was at all material times an alter ego of Ellsworth” and therefore found Seawatch and Ellsworth “jointly and severally liable for attorney’s fees incurred by XTO and the California heirs in responding to Seawatch’s frivolous claims. The trial court referred to this as “piercing the corporate veil” even though Seawatch was a limited liability company. More on this below.

Seawatch appealed the judgment on various grounds. The Court of Appeals affirmed the trial court’s judgment against Seawatch. The Colorado Supreme Court denied certiorari.

While the first appeal was pending, XTO and the California heirs filed motions seeking attorney’s fees and costs from Seawatch and Ellsworth. They also filed a joint motion to join Ellsworth to the post-judgment proceedings pursuant to C.R.C.P. Rule 21 and City of Aurora v. Colorado State Engineer.2 They were unable to serve Ellsworth (you can imagine him dodging service), and the trial court granted substituted service.

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1 2017 CO 109.
2 105 P.3d 595 (Colo. 2005).
Ellsworth (acting pro se) made what he referred to as a “limited appearance” in the trial court in 2013 to argue several motions, including that the trial court lacked personal jurisdiction and the substitute service had been improper. In April 2014, Judge Herringer (replacing Judge Dickinson who had retired) denied those and other Ellsworth motions. In reaffirming the alter ego holding, the trial court articulated several additional findings relevant to whether “piercing the corporate [sic] veil was necessary to achieve an equitable result.” The court found, for example, that:

a. Seawatch’s sole business function was to acquire the mineral deeds from the California Heirs for Ellsworth’s benefit, had no other business dealings, and was controlled entirely by Ellsworth;

b. Seawatch had no bank account and purchased the mineral deeds from the California heirs with personal checks from Ellsworth, and Ellsworth used personal checks or cash for other Seawatch expenses;

c. Seawatch was apparently insolvent and had no assets, such that limiting liability to Seawatch would foreclose any meaningful opportunity for injured parties to recover for conduct for which Ellsworth was responsible; and

d. There was no indication that Seawatch’s litigation strategy was controlled by anyone other than Ellsworth.

The trial court concluded that “[t]he only respect in which Ellsworth has treated Seawatch as a corporate [sic] entity, independent of him personally, is as a barrier to liability. . . . To the extent that Seawatch advanced frivolous argument and made groundless claims, Ellsworth is the person who should ultimately be held responsible for that conduct.” The trial court awarded fees and costs to XTO and the California heirs in May 2015. Ellsworth appealed pro se against his personal liability inasmuch as he alleged that he was not a proper party to the case. The Court of Appeals agreed with Ellsworth and vacated that part of the trial court’s judgment.

Ah, then the greed really kicks in. Ellsworth, having just been exonerated from personal liability by the Court of Appeals, files a petition for a writ of certiorari with the Colorado Supreme Court seeking “relief of manifest injustice to include $200,000,000 in exemplary damages pursuant to § 13-17-101 to punish the trial court’s and Respondent’s acts of frivolous, groundless and vexatious litigation.” Talk about hubris. After some further filings by Ellsworth, the Supreme Court denied Ellsworth’s petition for certiorari but granted the cross-petition filed by the California heirs to review the Court of Appeals’ ruling on whether Ellsworth had been properly joined in the case — leading to his liability on the alter ego theory.

**Piercing the Veil and Colorado’s Internal Affairs Doctrine**

The principal case is long over, but the history and the course of the litigation is fascinating. I have written several times about judicial decisions dealing with piercing the entity veil – not always in a favorable manner. I have also seen too many litigators discuss piercing the entity veil of a limited liability company without recognizing that, as the Colorado Supreme Court recognized in *Weinstein* (in connection with potential liability under C.R.S. § 7-80-606(2)), an LLC is not a corporation.

**The Internal Affairs Doctrine – Application of Wyoming Law Should Have Been Considered**

Seawatch is a Wyoming LLC. Colorado, like most other states, has adopted the “internal affairs” doctrine by which “As to any foreign entity transacting business or conducting activities in this state, the law of the jurisdiction under the law of which the foreign entity is formed shall govern the organization and internal affairs of the foreign entity and the liability of its owners and managers.” Thus, the court should have looked to Wyoming law, and specifically Wyo. Stat. § 17-29-304. Even

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4 C.R.S. § 7-90-805(4).
then, I think that the Colorado courts would have imposed liability on Ellsworth, but the fact remains that the Colorado courts did not even consider the applicability of Wyoming law.

**An LLC Is Not A Corporation And Does Not Have A Corporate Veil**

Even assuming that Colorado law (as applied by the courts and apparently argued by the Colorado litigators) was applicable, another failure was that the Supreme Court uses the phrase “corporate veil” 21 times. Only three times is the term used in reference to a corporation. The opinion refers to “corporate veil piercing” with respect to Seawatch, a limited liability company and not a corporation, at least eight times, including those mentioned above. The fact remains that a limited liability company does not have a “corporate veil” even though it is intended to provide liability protection to its members except as described in C.R.S. § 7-80-107 (again, assuming that Colorado law was applicable):

(1) In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited liability company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law.

(2) For purposes of this section, the failure of a limited liability company to observe the formalities or requirements relating to the management of its business and affairs is not in itself a ground for imposing personal liability on the members for liabilities of the limited liability company.

The Colorado Limited Liability Company Act requires the court to apply common law applicable to piercing the veil of corporations – but it does not say that the veil protecting the owners of an LLC is a “corporate veil.” It is not, and courts and the litigators presenting cases to the courts should not mischaracterize the nature of the LLC – it is an unincorporated entity.

(i) The Supreme Court’s opinion uses other language inappropriately when it cites the trial court in stating:

“Specifically, the trial court found that Ellsworth was the sole managing partner of Seawatch, which he owned with his wife and two adult children.” Please – an LLC does not have a managing partner or any partner at all. The owners are “members” and in this case of a manager-managed LLC, the manager is a manager.

(ii) The Court’s opinion also refers to Ellsworth as Seawatch’s “managing member” in several places. Under Wyoming law Seawatch was a manager-managed LLC and the articles of organization filed with the Wyoming Secretary of State named Ellsworth as the manager – not a “managing member.”

Words are important, and the courts in Colorado and the litigators who present cases to the courts should use the words correctly. The jurisdiction of organization of the entity is equally important, and litigators should argue, and courts should apply, the “internal affairs” doctrine properly. [The internal affairs doctrine was not discussed, and the Delaware organization of the LLC in question was ignored, in Martin v. Freeman as I discussed in an earlier newsletter.]

A failure to consider the correct law and to use the correct terminology can only confuse transactional lawyers and litigators looking at these cases for precedent.

In this case, however and notwithstanding the inappropriate use of words and the failure to consider the applicability of Wyoming law, the entity veil of Seawatch was in my opinion properly pierced based on the findings of fact made by the trial court and restated by the Supreme Court. The facts cited above confirm the conclusion of the trial court and recited by the Supreme Court that “[t]he only respect in which Ellsworth has treated Seawatch as a corporate [sic] entity, independent of him personally, is as a barrier to liability.” Seawatch had no bank account or separate accounting, and it was clear from the facts as determined by the trial court that Ellsworth used Seawatch to operate a fraud on the California heirs and XTO.
Was Ellsworth Properly A Party?

Of course, if the trial court did not have jurisdiction over Ellsworth, he never would have been liable for damages as a result of the court’s piercing the entity veil. For that reason, he should have stopped at the Court of Appeals decision reversing the trial court and accepting his argument that he did not have personal liability because of a lack of jurisdiction. Whether the California heirs would have appealed that decision is unknown; perhaps they were just relieved that the matter was over. Ellsworth’s efforts to seek a $200,000,000 vindication on a pro se basis backfired on him.

In its opinion, the Supreme Court acknowledged “that a person is not bound by a judgment if he was not ‘designated as a party or ... made a party by service of process,’”5 Considering the facts, however, the Court concluded “that Ellsworth was a party to the post-judgment proceedings” based on the Court’s interpretation of the City of Aurora case. In City of Aurora, after the trial court entered its order of dismissal following an eight-week trial, the prevailing party sought attorneys’ fees and costs under C.R.S. §13-17-102(4). The prevailing party moved to join Aurora solely “for purposes of collecting attorney fees and costs.” The court granted joinder, and the Supreme Court affirmed. The Court explained the City of Aurora decision as follows [citations omitted]:

Parties may be dropped or added by order of the court on motion of any party ... at any stage of the action and on such terms as are just.” ... (quoting C.R.C.P. 21). Rules 20 and 21, which should be “liberally construed,” specifically “authorize joinder in situations where one party seeks to join a person who may be liable for the same debt or conduct that is already before the court.” ... These rules “indicate clearly a general policy to disregard narrow technicalities and to bring about the final determination of justiciable controversies without undue delay.” ... Thus, we held, joinder of Aurora was not an abuse of discretion, even though the court had already entered judgment on the merits.

[b]ecause C.R.C.P. 20 allows joinder at any stage of the proceedings and because C.R.C.P. 21 anticipates joinder where there are joint liabilities, as well as common questions of law and fact,” and Aurora “was potentially liable for conduct that was already before the court.”

The Supreme Court concluded “that Ellsworth, who was properly joined to the post-judgment proceedings, had notice and opportunity to contest his individual liability.”

Conclusion

Stockdale v. Ellsworth is an interesting case from several angles, factual, legal and procedural. It was properly decided under Colorado law and, I suggest, even under Wyoming law had the Colorado courts properly considered the Colorado internal affairs doctrine. We can only ask that, when applying entity legal principles, the courts, and the attorneys practicing before the courts, choose their words, and applicable law, more carefully. Doing so will avoid confusion and problems for practitioners and their clients.

The 2018 LLC Institute

Hold the Date

The 2018 LLC Institute will take place October 11-12. The Institute will be held at the Westin Washington D.C. City Center in (you guessed it) Washington, D.C.

Please mark your calendar now to attend the 2018 LLC Institute.

Piercing, Reverse Piercing (Inside And Outside)

By: Gerald V. Niesar
Niesar & Vestal LLP
San Francisco, California

Curci Investments, LLC v. Baldwin,\(^1\) held that, in the context of a limited liability company, the creditor of a member may, in appropriate circumstances “reverse pierce” the LLC as a way to obtain assets to satisfy his claim against the Member. In reaching this result, the Curci Investments court distinguished an earlier California case, Postal Instant Press, Inc., v. Kaswa Corp.,\(^2\) which held that, in California, “a third party creditor may not pierce the corporate veil to reach corporate assets to satisfy a shareholder’s personal liability.”

1. Traditional Piercing the Veil of a Corporation.

Piercing the veil of a corporation (or LLC) is alternately referred to as the “alter ego” doctrine. Those of us who went to law school before any human walked on the moon can recall seeing a list of 20 to 25 factors that were examined to see if a corporate shield should be pierced to hold a shareholder responsible for a corporate obligation. Over the years this has evolved to essentially a two-step analysis most recently and comprehensively analyzed in Sonora Diamond Corp. v. Superior Court.\(^3\) The two steps consist of demonstrating: (1) there is a unity of interest and ownership between the corporation and its owners such that separate personalities of the two do not in reality exist; and (2) an inequitable result would ensue if the wrongful acts (e.g., non-payment of a debt) were treated as acts of the corporation alone. So, generally, courts no longer look to see if meetings are held, officers were appointed, or whether there was at some time adequate capitalization, etc.

2. Reverse Piercing.

Reverse piercing, as the name implies, goes the other way. It is used to show that an asset of the corporation may actually be the asset of a corporate insider (“inside reverse piercing”), or that the assets of the corporation may be reached to satisfy an obligation of a shareholder to the shareholder’s creditor (“outside reverse piercing”). Examination of inside reverse piercing is not within the scope of this article.

Application of the outside reverse piercing doctrine starts with an analysis of the shareholder’s obligation that is being ignored, avoided, dodged, shunned, etc. If that shareholder holds a controlling interest in a corporation, and is using the corporation as his bank account, keeping all of his assets in the corporation and out of the reach of his creditor(s), can the creditor seek to have his judgment against the shareholder expanded to add the corporation as an additional debtor? Code of Civil Procedure Section 187 permits this modification/expansion of the judgment in the case of normal piercing/alter ego. But, as noted above, Postal Instant Press held that California law does not recognize reverse piercing.

Postal Instant Press, however, involved a corporation as the entity sought to be held liable on a shareholder’s debt. In a corporation, there are four principal reasons why reverse piercing should be discouraged: first, other shareholders’ rights would be prejudiced if corporate assets are, in effect, distributed to one shareholder as would happen in reverse piercing; second, other corporate creditors would be prejudiced as the payment to the shareholder’s creditor puts that shareholder’s equity interest ahead of creditor claims; third, the shareholder’s creditor can seek an order having the stock transferred to the creditor whereby the creditor obtains 100% of the interest of the shareholder in the corporation, most importantly including voting rights; and, fourth, legal remedies, such as conversion, fraudulent conveyance (now voidable transfer), aiding and abetting, etc., are available to remedy all but the most unusual abuses of the corporation.

In the LLC context, that third factor is just not available. A creditor who obtains the LLC member’s interest via foreclosure of a

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\(^3\) 83 Cal. App. 4th 523 (5th Dist. 2000).
charging order lien is merely a transferee of a transferable interest, not a full member. The creditor may be able to get a charging order against the LLC, but that only allows the creditor to be paid any distributions that would be payable to the member. The first, second and fourth factors, however, do militate against reverse piercing in the LLC situation as much as they would in the corporate context.

In Curci Investments, Curci had been chasing Baldwin for several years on a judgment for $7.2 million. But Baldwin had all his money and assets in an LLC called JPB Investments, LLC (“JPBI”). The owners of JPBI were Baldwin (99%) and his wife (1%). Baldwin was the sole manager. In the several years before the judgment against Baldwin had been entered, JPBI had distributed at least $178 million to Baldwin and his wife, but not a single cent had been distributed after the date of the judgment. Meanwhile, some $42.6 million of debts owed by various Baldwin family members to JPBI came due, but Baldwin extended the due dates of those notes with no consideration being paid for the extensions. The Court held that Baldwin was simply using the LLC as his personal bank account, the creditor did not have an effective remedy to reach JBPI’s assets by getting a charging order, or even foreclosing on the Baldwin interests in the LLC, and the Postal Instant Press case should not be viewed as binding in the case of a reverse piercing where the entity is an LLC and not a corporation. Recall that in a reverse piercing situation, the entity becomes a joint judgment debtor; as a result, the creditor has a direct claim against the LLC and can therefore reach its assets directly. The Curci Investments opinion specifically rejected the notion that the LLC member’s creditor was bound by the LLC Act’s mandate that the exclusive remedy of a creditor claim against a Member is a charging order, citing Corporations Code Section 17705.03. The opinion notes that the statute provides that the charging order is the exclusive remedy available to a creditor to “satisfy the judgment from the judgment debtor’s transferable interest.” Then the opinion continues: “Reverse piercing is a means of reaching the LLC’s assets, not the debtor’s transferable interest in the LLC” and goes on to note that the Commentary to Section 503 of the Revised Uniform Limited Liability Company Act (“RULLCA”) states that the charging order provisions are “not intended to prevent a court from effecting a ‘reverse pierce’ where appropriate.”

3. What About the Internal Affairs Doctrine?

The Curci Investments opinion has eleven citations to California Corporations Code sections included in California RULLCA, as well as the reference to the RULLCA Commentary noted above. But at the beginning of the statement of “Facts and Procedural History”, the opinion notes: “Baldwin formed JPBI, a Delaware limited liability company.” That is the only reference to Delaware in the entire opinion. However, with that one reference to Delaware, it seems appropriate to look at and compare the relevant sections of the California and Delaware LLC Acts.

California Corporations Code Section 17705.03 provided:

(a) On application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. ……

(b) To the extent necessary to effectuate the collection of distributions pursuant to a charging order in effect under subdivision (a), the court may do any of the following:

(1) ....
(2) ....
(3) Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, foreclose the lien and order the sale of the transferable interest. The purchaser at the foreclosure sale obtains only the transferable interest, does not thereby become a member, and is subject to section 17705.02.

(c) ..... 
(d) ....
(e) ....
(f) This section provides the exclusive remedy by which a person seeking to enforce a judgment against a member or transferee may, in the

4 Curci Investments at page 849.
capacity of judgment creditor, satisfy the judgment from the judgment debtor’s transferable interest.

Delaware Limited Liability Company Act Section 18-703 provided:

(a) On application by a judgment creditor of a member or of a member’s assignee, a court having jurisdiction may charge the limited liability company interest of the judgment debtor to satisfy the judgment. ....

(b) ....

(c) ....

(d) The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or a member’s assignee may satisfy a judgment out of the judgment debtor’s limited liability company interest and attachment, garnishment, foreclosure or other legal or equitable remedies are not available to the judgment creditor, whether the limited liability company has 1 member or more than 1 member.

(e) No creditor of a member or of a member’s assignee shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company.

(f) ....

So, where does this leave us with respect to which law should apply? With respect to limited liability companies, California addresses the internal affairs doctrine in Section 17708.01(a) in a somewhat circular statement:

“(a) The law of the state or other jurisdiction under which a foreign limited liability company is formed governs all of the following:

(1) The organization of the limited liability company, its internal affairs, and the authority of its members and managers.

(2) The liability of a member as member and a manager as manager for the debts, obligations, or other liabilities of the limited liability company.

The circularity is the reference in (a)(1) to “the internal affairs”. The U.S. Supreme Court provided a good statement of the internal affairs doctrine in *Edgar v. MITE Corp.*, 5 “the internal affairs doctrine is a conflict of laws principle which recognizes that one State should have authority to regulate a corporation’s internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders—because otherwise a corporation could be faced with conflicting demands.”

The charging order is often described as being based upon the “pick your partner” rule. Thus, a creditor of a partner could not take over the interest of the partner in satisfaction of his claim against the partner, and thereby become a partner in the partnership against the will of the other partners. As such, the essence of the charging order procedure is to ensure that the other partners cannot be forced to have a partner they did not voluntarily choose. And the natural result of that underlying principle is that the charging order procedure deals with one of the most fundamental internal matters of any entity—who are my partners?

A countervailing argument could be founded on the principle that matters concerning an entity’s obligations to its creditors are not internal matters and should be governed by the law of the entity’s principal place of business, or where the debtor-creditor relationship was established. However, the important word in that sentence is “its”; i.e., the external law governs the rights of a creditor of the entity. But a charging order does not deal with the rights of an entity creditor, and certainly reverse piercing does not deal with the rights of an entity creditor unless and until the judgment against a member is expanded to be a judgment against the entity as well. But that latter can only happen in the case of a Delaware entity if one ignores the provisions in Section 18-703(e) by which a creditor of a member is prohibited from exercising any legal or equitable remedy with respect to the property of the limited liability company.

It should be noted that the *Curci Investments* opinion only directed the matter back to the trial court to determine whether, under its particular set of facts, reverse piercing is appropriate. Nevertheless, unless *Curci Investments* is overturned by another appellate court or the California Supreme Court, it establishes the law in California that reverse piercing “in an appropriate case” may be pursued where the debt at issue is that of a member in a limited liability company. It further stands for the proposition that the issue of reverse piercing in the context of a limited liability company is not a matter subject to the internal affairs doctrine whereby the court will look to the law of the state of formation to determine whether it is permissible.

### Trying To Get Some Traction On The Series Classification Regulations

In 2010, the IRS released proposed regulations addressing the tax classification of series. As most of you know, these regulations are largely consequent to the work of Steve Frost who was then working at Treasury. Unfortunately, since then, nothing has happened. Well, nothing has happened at the IRS. On the state law front, numerous states have adopted series provisions in their LLC Acts. In 2017, the Uniform Law Commission completed the Uniform Protected Series Act.

Presumably in an effort to spark some action, a letter has been submitted to various officials at the Treasury/IRS advising them of the adoption of the Uniform Protected Series Act. Whether this letter will spur any action remains to be seen.
Special Proceeding Seeking a Judicial Decree to Dissolve an LLC

By: Michael Farinacci and Stephen P. Younger
Patterson Belknap Webb & Tyler LLP
New York, New York

In Advanced 23, LLC v. Chambers House Partners, LLC, Justice Saliann Scarpulla of the Commercial Division ruled that Advanced 23, LLC (“Advanced”) and David Shusterman’s (“Shusterman” and collectively, “Petitioners”) petition for judicial dissolution of Chambers House Partners, LLC (“CHP”) needed to be held in abeyance pending an evidentiary hearing on whether Shusterman had breached his duties under the Operating Agreement. Advanced 23 confirms that although a corporate deadlock is not an independent ground to dissolve an LLC, the court must still examine whether the managers’ disagreement breaches the managers’ obligations under the LLC operating agreement.

Factual Background

CHP has owned and operated a building located at 154 Chambers Street in Manhattan (“the Building”) since January 18, 1982. Anita Margrill (“Anita”) and Herbert Margrill (“Herbert” and collectively, “the Margrills”) each hold a 25% membership interest in CHP. Advanced purchased a 50% membership share on February 1, 2013. According to its Operating Agreement, CHP’s business purpose is “to own and operate the building known and located at 154 Chambers Street, New York, NY 10013 . . . ; to provide a residence for its Members; and to conduct any lawful business as the Members may from time to time determine.” Under the Operating Agreement, Shusterman and Herbert were co-managers with equal votes and material business decisions required a majority vote or unanimous consent of all members.

Shortly after Advanced purchased its interest in CHP, tensions began to escalate between Shusterman and the Margrills. In 2015, Anita allegedly harassed Shusterman’s girlfriend and entered his apartment without permission. Then, according to the petition, Anita and Shusterman had a physical altercation, which resulted in police involvement. Additionally, Herbert had to hire an attorney to negotiate with Shusterman regarding the Operating Agreement’s obligations.

Petitioners alleged that the Margrills took unilateral actions in violation of the Operating Agreement. First, the Margrills allegedly created a separate bank account for CHP to deposit the Building’s rent. Next, the petition asserted that the Margrills transferred $75,000 from CHP’s existing bank account into this new account without Shusterman’s knowledge; withdrawals from the existing account required the signatures of both managers. Thereafter, the Margrills unilaterally granted a tenant’s request to use her security deposit as payment for the rent.

Petitioners commenced this special proceeding by a verified petition seeking, inter alia, a judicial decree dissolving CHP.

Discussion

In a special proceeding, the Commercial Division is to use the same standard of review as is used on a summary judgment motion and is to make a determination on the pleadings and

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2 The Building contains one commercial unit and four residential units. Id. at *1.
3 The Building was originally owned by a general partnership until November 8, 2007, when it was sold to CHP. Id.
4 Shusterman owns 100% of Advanced. Id.
5 Id.
6 Id.
7 Id. at *1-2. Dissolution required unanimous consent.
8 Id. at *2.
9 Id.
10 Id. at *3.
11 Id.
12 Id.
13 Id.
14 Id.
papers to the extent there is no triable issue of fact.\textsuperscript{15}

Given that LLCs are created by statute, the Justice Scarpulla looked to the N.Y. Limited Liability Company Law. Section 702 provides that a court may order the dissolution of an LLC "whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement."\textsuperscript{16} Practicality is a fact-specific determination that requires a court to exercise discretion.\textsuperscript{17} The petitioner must show either that the under the circumstances, it is financially unfeasible to continue operating the business or management is unable or unwilling to promote the LLC’s business goals.\textsuperscript{18}

The court cautioned that a judicial dissolution of an LLC is a drastic remedy; a deadlock between LLC managers cannot be the sole reason for judicial dissolution.\textsuperscript{19} Rather, the court must evaluate the deadlock in the context of the operating agreement in order to assess whether the business can continue to operate despite the disagreement.\textsuperscript{20}

In this case, the Commercial Division ruled that the Petitioners had made a prima facie showing that it was no longer practicable for CHP to achieve its stated business purpose because any material business decision, at a minimum, required a majority vote and the co-managers were not even on speaking terms.\textsuperscript{21} Herbert had undermined Shusterman’s right to co-manage CHP when he made unilateral decisions in violation of the Operating Agreement. Here, the Operating Agreement required cooperation between the co-managers to achieve CHP’s business goals and the deterioration of the relationship between Shusterman and Herbert makes the continued operation of CHP impossible.

Nonetheless, the Commercial Division also held that Respondents had raised a triable issue of fact as to whether Shusterman had breached his duties under the LLC’s Operating Agreement.\textsuperscript{22} Respondents alleged that Shusterman had attempted to force a dissolution and acquire control of the Building by interfering with CHP’s operation—thereby breaching his managerial obligations by delaying CHP’s ability to pay its operating expenses.\textsuperscript{23} As a result, the court ruled that a judicial dissolution could not be ordered at this time. Instead, the court ordered an evidentiary hearing before a Special Referee to determine whether Shusterman had breached his duties under the Operating Agreement by trying to force CHP’s dissolution, and it held the dissolution petition in abeyance pending the Special Referee’s findings.\textsuperscript{24}

\textbf{Conclusion}

Although deadlock alone is not a viable ground to dissolve an LLC, the underlying acts may give rise to a sufficient predicate to dissolve an LLC. Nonetheless, if there are sufficient factual issues about whether LLC management has breached their duties, those breaches can be used to hold off a dissolution order.


\textsuperscript{15} Id. at 4; CPLR § 409.
\textsuperscript{16} N.Y. Ltd. Liab. Law § 702.
\textsuperscript{17} Id.
\textsuperscript{18} Id. at *4-5.
\textsuperscript{19} Id. at *5.
\textsuperscript{20} Id. When an LLC can achieve its business purpose despite the disagreement, then dissolution will not be ordered. “See, e.g., Belardi-Ostroy, Ltd. v. American List Counsel, Inc., 2016 BL 128258, at *5-6 (NY. Sup. Ct. 2016 Apr. 14, 2016) (“the Operating Agreement provides a straightforward means of avoiding deadlock — having a tie-breaking fifth member on the Board.”); Goldstein v. Pikus, 2015 BL 258452, at *19-21 (NY. Sup. Ct. July 20, 2015) (finding that dissolution was not warranted despite the parties being deadlock over whether to sell or convert the property because the property was being managed and operated by an independent managing agent); Matter of Dissolution of 1545 Ocean Ave., LLC, 72 A.D.3d 121, 131 (2d Dep’t 2010) (finding that deadlock is not possible because the operating agreement “permit[s] each managing member to operate unilaterally in furtherance of [the limited liability company’s] purpose”).” Id. at *5-6.
\textsuperscript{21} Id. at *5.
\textsuperscript{22} Id. at *6.
\textsuperscript{23} Id.
\textsuperscript{24} Id. at *6-7.
On Cloaking Devices and Usury: Lender Can Be Sued If It Uses Corporate Shell To Cloak A Personal Loan As a Business Loan

By: Peter J. Gallagher
Porzio, Bromberg & Newman P.C.
Morristown, New Jersey

Cloaking devices are common in sci-fi movies like Star Trek and Star Wars. They are used to render an object, usually a spaceship, invisible to nearly all forms of detection. Although scientists are apparently working to make real-life cloaking devices, at this point they exist only in the movies and, apparently, in New Jersey courts, at least according to the Appellate Division in Amelio v. Gordon.¹

In Amelio, plaintiff owed an apartment building in Hoboken. He approached defendants about obtaining a loan to finish renovations on three units in the building, along with the common areas. Plaintiff claimed that defendants instructed him to create a corporate entity to obtain the loan. Plaintiff did as he was instructed, and formed a limited liability company, which obtained the loan from defendants. Plaintiff, who was identified as the managing member of the limited liability company, signed the loan documents on behalf of the company.

Plaintiff later sued, arguing that the fees and interest payments under the loan exceeded the amounts allowable under New Jersey’s usury laws. He also claimed that defendants fraudulently convinced him to create a limited liability company and have that entity obtain the loan, just so they could charge him usurious fees and interest. Plaintiff sued in his individual capacity, not on behalf of the limited liability company. On the day of trial, defendants argued that the complaint had to be dismissed because plaintiff lacked standing to sue since the company was the borrower, not plaintiff. With little explanation, the trial court granted the motion and dismissed the complaint. Plaintiff appealed.

The Appellate Division reversed the trial court. It held that plaintiff had standing to sue defendants, and, in fact, was the only one with standing to do so.

Under New Jersey law, a limited liability company is not allowed to "plead or set up the defense of usury to any action brought against it to recover damages or enforce a remedy on any obligation [that it] executed." New Jersey courts have extended this prohibition to individual endorsers or guarantors of a corporate loan. This would appear to foreclose any claim by plaintiff in Amelio -- whether brought by plaintiff, individually, or by the limited liability company -- that the terms of the loan from defendants were usurious. This, however, is where the cloaking device comes in.

In Amelio, the Appellate Division noted that "an individual can recover usury payments on a loan made to a corporation if the individual can prove that the lender fraudulently caused the individual to create the corporation as a device to evade the usury laws." Stated differently, "a lender cannot evade the usury laws by using a corporate shell to cloak a loan that, in effect, is actually being made to an individual borrower." The Appellate Division held that an individual cannot take advantage of this exception if "the corporation is not a shell and was not formed solely to cloak the loan." In doing so, it cited to Selengut v. Ferrera, a case involving a "legitimate preexisting corporation," which "had a significant economic life of its own, predating the loan" and "owned property that was valuable and that was separate and apart from the loan," and which therefore was not created simply to cloak an individual loan as a corporate loan. But if the corporation was created just to cloak the loan, then the exception applies.

In Amelio, the Appellate Division concluded that defendants were correct that plaintiff could not assert individual claims based on alleges breaches of the loan documents. But, because the complaint could be read to allege a claim that he was fraudulently induced into creating a limited liability company as a way for defendants to subvert the usury laws, defendants’ motion to dismiss should have been denied.

Can a Non-Physician Own and Operate a Medical Facility in Michigan?

By: Gary J. McRay and Julie LaVille Hamlet
Foster Swift Collins & Smith PC
Michigan

An interesting case is winding its way through the Michigan Court of Appeals that involves the question of whether a layperson, as opposed to a licensed physician, can own a for-profit business that provides medical services.

The appeal stems from a lawsuit filed by the Michigan Radiological Society (the “MRS”) against Oakland MRI, a non-physician owned limited liability company that offers diagnostic imaging services.

Last year, the Oakland County Circuit Court ruled in favor of Oakland MRI, holding that Oakland MRI is permitted to operate in Michigan as an LLC and that its owner, a gemologist by trade, is not required to be a licensed physician in order to own and operate the diagnostic imaging center.

MRS has argued (and is arguing on appeal) that the state of Michigan erroneously allowed Oakland MRI to be organized as an LLC and that its owner, a gemologist by trade, is not required to be a licensed physician in order to own and operate the diagnostic imaging center.

The appeal will require an interpretation of the Corporate Practice of Medicine (“CPOM”) doctrine. The CPOM doctrine was first implemented by the American Medical Association, and its principles have been adopted in Michigan through provisions in various state statutes. The CPOM doctrine prohibits unlicensed individuals and entities from engaging in the practice of medicine and owning medical facilities. The CPOM doctrine includes exceptions for non-profit hospitals and both non-profit and for-profit nursing homes.

Section 4(3) of the Professional Service Corporation Act states that if a professional corporation is organized to provide a professional service that is subject to Michigan’s Public Health Code then all of the professional corporation’s shareholders must be “licensed or legally authorized” in Michigan to provide the same professional service. An identical restriction is contained in Section 904(2) of the Limited Liability Company Act.

This case will require the Court of Appeals to consider whether Michigan’s statutory scheme prohibits non-physician ownership of a medical facility, or whether a non-licensed layperson (like Oakland MRI) may own a facility as long as licensed physicians provide the actual medical services.

This case could open the door for more competition against the existing non-profit health industry in Michigan by non-licensed owners.

Wyoming Adopts Series LLC Legislation

The Wyoming Legislature has approved H.B. 0126, it amending the Wyoming LLC Act and adding series provisions.

The series provisions added to the Wyoming LLC Act are not (so it would appear) based on the Uniform Protected Series Act.

The Act has an effective date of July 1, 2018.
Pitfalls in Non-Deed Transfers: The Controlling Interest Transfer Tax

By: Jeffrey A. Zenn  
Cullen and Dykman LLP  
Hackensack, New Jersey

Your client calls you and says that rather than incur a realty transfer fee and a mansion tax upon the acquisition of commercial property, she would prefer to acquire the interests in the entity that owns the real property, thereby avoiding the realty transfer fee and the mansion tax that would be due by the buyer. Her rationale is that as the buyer she would save on the mansion tax and if the seller did not have to pay a realty transfer fee that savings could be passed along to her, as the buyer. Aside from the obvious perils of inheriting the obligations of the entity, be aware that your client may not get what she intended.

If there is a non-deed transfer, it is true that a realty transfer fee will not be incurred. However, the Controlling Interest Transfer Tax (CITT), N.J.S.A. 54:15C-1, was enacted in 2006 to prevent taxpayers from avoiding the 1 percent tax on direct transfers under the mansion tax. The CITT is fairly narrow in its scope, but the ramifications can be very profound. The mansion tax imposes a 1 percent tax on direct transfers of classified commercial real property for a consideration in excess of $1 million. The CITT prevents taxpayers from avoiding the 1 percent tax on direct transfers by instead transferring ownership interests in the entity owning the real property.

Differences Between CITT and Mansion Tax

The mansion tax is imposed on transfers of real property that are classified as residential (Class 2), farm property (Class 3A) and commercial properties (Class 4A). The CITT, however, only imposes a transfer tax upon a sale or transfer of a controlling interest in classified real property. Classified real property for purposes of the CITT means Class 4A income-producing commercial properties. The definition of Class 4A income-producing commercial properties means any type of income-producing property other than vacant land (Class 1), residential property (Class 2), farm property (Class 3), industrial properties (Class 4B) and apartments (Class 4C). So, apartment buildings that are for five or more families are Class 4C and therefore are not included within the realm of the CITT. However, office buildings and other commercial properties that are income-producing properties are Class 4A and subject to the CITT.

What Transfers Are Covered?

There must be a sale or transfer of controlling interest in an entity. Controlling interest means: (i) in the case of a corporation, more than 50 percent of the total combined voting power of all classes of stock of the corporation; or (ii) in the case of a non-corporate entity, more than 50 percent of the beneficial ownership of the entity. The regulations implementing the CITT define "beneficial ownership" as ownership by a person or entity that does not have legal title to the property but has the ultimate control of the property in regard to the transfer of a controlling interest. The CITT "may apply to the transfer of control of an upper tier entity of a chain where a lower tier entity owns classified real property, as well as to a transfer of control of the direct owner of real property." N.J.A.C. 18:16A-1.5(a). For example, assume ABC LLC owns classified real property and is more than 50 percent owned by DEF LLC. If individual X acquires a majority interest in DEF LLC from individual Y, the CITT would apply. That is because the ultimate control over the entity that owns the income-producing real property has changed.

Calculating the CITT

If the controlling interest of an entity just owning classified real property is transferred, the calculation of the CITT is relatively straightforward. That is, if A acquires from B the full ownership interest in ABC LLC which owns classified real property and the price paid is in excess of $1 million, then the tax is 1 percent of the consideration paid for the transfer. Consideration means the actual amount of money and any other thing of value constituting the entire compensation paid for the transfer, including the remaining amount of any prior mortgage to which the transfer is subject or which is to be assumed and agreed to be paid by the purchaser. The calculation of the tax,

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however, becomes far more complicated if a controlling interest is purchased in an entity that owns not only real property but other property, real or personal. Then the tax calculation is not based on the amount paid for the interest itself, but on the equalized assessed value of the classified real property multiplied by the percentage ownership transferred.

Assume J owns 60 percent and K owns 40 percent of the shares in Corporation A and Corporation B is a 100 percent owned subsidiary of Corporation A. Corporation B is the sole member of a limited liability company that owns classified real property with an equalized assessed value of $1.2 million and common stock worth $2 million. If J sells all his stock in Corporation A to L for $200,000, taxes are due because J has sold the controlling interest in the classified property because the percentage of shares sold is greater than 50 percent of the total combined voting power of all classes of Corporation A stock. Since J transferred controlling interest of an entity owning classified property and other property (here, common stock), the tax due is calculated using the second method which is 1 percent multiplied by the consideration multiplied by the percentage transferred (60 percent). In this method, the equalized assessed value of the classified property, not the amount of consideration paid for the controlling interest itself, is used in the calculation of the tax. So, in this case it would be 1 percent multiplied by the equalized assessed value ($1.2 million) times 60 percent, which equals $7,200.

If Corporation B is the sole member of a limited liability company that just owns classified real property with an equalized assessed value of $1.2 million and nothing else, and J sold his stock for $200,000, then in that case no tax is due because the consideration is less than $1 million. However, if one were to change the facts by assuming the classified real property has a mortgage of $1.2 million, then tax would be due because even though J sold his stock for only $200,000, the consideration includes the amount of the mortgage, which is $1.2 million. Thus, the tax in this scenario is $14,000 calculated as 1 percent of $1.4 million ($200,000 + $1.2 million).

In this next example, assume LLC 1 owns 51 percent of the fee simple interest in classified real property. LLC 2 owns the other 49 percent interest in the same property and no other property. H owns 100 percent of LLC 2 and sells this interest to a third party for $2 million. The transfer of H's controlling interest in LLC 2 is not subject to CITT because LLC 2 does not possess a controlling interest in classified real property.

Finally, assume Corporation A is 100 percent owner of both Corporation B and Corporation C. Corporation B is the member of SM LLC which owns classified real property. If Corporation B transfers the interest in SM LLC to Corporation C for $5 million, there is CITT. Although ultimate control of the classified property remains in Corporation A, direct control of the property has changed from Corporation B to Corporation C which are two separate legal entities. Therefore, the purchaser, Corporation C, pays a 1 percent tax on the consideration because it has acquired direct control of SM LLC and its classified property, independent of any beneficial ownership the corporation may have over the two separate legal entities.

Where classified real property has a mortgage on it, the effects on the calculation of the tax can be very significant. For example, assume that the controlling interest of an entity owning classified real property worth $15 million with a mortgage of $10 million is transferred for $5 million. In that situation, the purchaser will actually pay $5 million for the interest ($15 million less the amount of the mortgage). However, the purchaser would be subject to a CITT of $150,000 (1 percent of $15 million) which in essence constitutes 3 percent of the purchase price paid for the membership interest. Thus, the effective tax can be much higher.

**Exceptions**

To be sure, there are certain exceptions to the CITT. No tax shall apply to any sale or transfer by or to a governmental entity. Also, if the purchaser is a tax-exempt entity under IRC Code Section 501(c)(3), there is no CITT. The CITT does not apply to any transaction that would be exempt from the realty transfer fee. Additionally, the CITT does not apply to a sale that is incidental to a corporate merger or acquisition if the equalized assessed value of the classified real property transferred is less than 20 percent of the total value of all assets exchanged in the merger or acquisition.\(^4\)

\(^4\) N.J.A.C. 18:16A-1.3(a)(5).
Compliance

In order to comply with the CITT, on or before the last day of the month following the month when the sale or transfer of the controlling interest was completed, the purchaser/transferee must file a return on form CITT-1 with the New Jersey Division of Taxation. It is a two-page form which must be accompanied with the payment of the tax when filed. Additionally, the purchaser/transferee must also provide a copy of the CITT-1 to the seller/transferor, and a copy of the return must be attached as an exhibit to the seller/transferor’s business tax return filed with New Jersey. If an exemption is claimed, then a separate Statement of Waiver (Form CITT-1E) must be filed also.

To avoid unanticipated financial obligations, it is imperative to understand the controlling interest transfer tax implications when negotiating non-deed transfers of real property.

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Joint Editorial Board for Uniform Unincorporated Business Entity Acts

The Joint Editorial Board for the Uniform Unincorporated Business Entity Acts met in Chicago on March 2. Items discussed include:

- the status of the resolution of Sections 9-406/9-408 of the UCC regarding LLCs and partnerships;
- confirmation of the prior decision to delete § 302(d) of RUPA;
- the debate pending in Florida and elsewhere as to the comments to § 4 of the Uniform Voidable Transaction Act and certain statutory issues regarding entity formation issues;
- what is a post-dissolution “opportunity” and when may it be utilized versus when is it an opportunity of the dissolving LLC/partnership?
- whether the “protected agreement” concept is a necessary concept at this time;
- efforts to properly distinguish a “series” of stock or other interests from a “protected series”;
- possible (but at this point unlikely) editing to the charging order statutes;
- the definition “partnership” in RUPA; and
- a status report of what uniform unincorporated acts are pending in the various legislatures.

The current chair of the JEB is Scott Ludwig, and the current secretary is Lisa Jacobs. Other members appointed by the Committee are Lou Conti, Beth Miller and Tom Rutledgei. Other members appointed by the ULC are David Walker, Thomas Geu, and Steve Leitess. Also at the meeting were emeritus members Paul Altman and Allan Donn.

In 2017, after many years of service, Professor Dan Kleinberger resigned as the research director for the JEB. Jim Wheaton has accepted the role for 2018 and future years.
Why Delaware Statutory Trusts Are Becoming Popular

By: Joseph J. Whitney, David Shechtman and Angela R. Raleigh
Drinker Biddle & Reath
Florham Park, New Jersey

Section 1031 of the Internal Revenue Code is an important tool that allows real estate investors and property owners to exchange one business or investment property for another without immediately incurring taxes. This transaction, often referred to as a "1031 exchange" or "like-kind" exchange, allows an investor to reinvest the full amount of net sale proceeds into new investments while deferring capital gain taxes until the investor eventually cashes out. In recent years, Delaware statutory trusts (DSTs) have grown in popularity as replacement properties for real estate owners seeking to reinvest sale proceeds into net-leased properties producing a steady stream of income. The DST's structure also permits investors to engage in a subsequent 1031 exchange if they decide to sell their beneficial interest in the trust or when the trust terminates. However, in order to receive such tax-deferred treatment, DST investors should be aware of several important restrictions and limitations.

A DST is a statutory form of business trust governed by Del. Code Ann. Title 12, §3801-62. Generally, business trusts enjoy many benefits similar to limited liability companies, including pass-through taxation, insolvency protection, limited liability for both the trustee and investors, and flexibility in arranging the trust's governance structure. This flexibility allows investors to structure DSTs to impose specific limits on the trustee and trust property necessary to satisfy the requirements to treat a beneficial interest in the DST as a direct interest in real estate for tax purposes.

In order to facilitate 1031 exchanges, DSTs hold investment property in fee simple and allow investors to purchase a pro rata beneficial interest in the trust. A DST typically exists for a limited period of time, as provided by the trust's governing instrument, until the trust property is sold on behalf of investors. Upon termination, the trustee distributes the net sale proceeds to the beneficial owners in accordance with their pro rata interests, and, if the DST has been properly managed, each owner may reinvest its pro rata share in another 1031 transaction. An investor can also sell his or her interest prior to the trust's termination, and use the proceeds to commence another 1031 exchange.

Prior to utilizing DSTs, investors looking to pool money for larger 1031 replacement property investments were limited to entering into tenancy-in-common (TIC) arrangements. TICs were not and are not without their own limitations. Revenue Procedure 2002-22 (2002) (the "TIC Revenue Ruling") imposes certain requirements which must be met in order for the TIC arrangements to be respected as a direct ownership of real property (and thus, eligible as 1031 replacement property) and not re-characterized as a tax partnership (ineligible for 1031 treatment). The TIC Revenue Ruling limits TICs to no more than 35 co-investors. TIC investors typically create single-purpose, single-member limited liability companies to hold their undivided interests and shield themselves from liability. Those individual limited liability companies must then jointly arrange for financing, creating a potential closing nightmare for lenders in having to deal with up to 35 separate borrowers. The TIC Revenue Ruling also requires unanimous consent of all TIC co-investors on all major decisions (including leasing and refinancings), which can make for a burdensome governing structure. Because the DST structure solves many of the limitations imposed by the TIC Revenue Ruling, use of DSTs has increased. For instance, the DST itself shields investors from liability, acts as the sole borrower for any loans, and centralizes management with the trustee.

Like an investment in a TIC structure (but unlike an investor who acquires ownership of a membership interest in a limited liability company), an investor in a DST may be treated as owning an undivided interest in the property itself. Accordingly, a properly structured DST can avoid Section 1031's prohibition on exchanges of partnership interests because beneficial owners are considered to be selling and exchanging a portion of real property, not an interest in an entity.

In Revenue Ruling 2004-86 (2004), the Internal Revenue Service specifically approved the use of DSTs in 1031 exchanges (a "1031 DST"), but established prohibitions on the DST trustee's powers and activities (now known as
the "seven deadly sins") to ensure that the DST acts more like a typical passive "investment trust" than an operating business entity. A 1031 DST must have only a single class of beneficial interests and the trustee must:

- Not renegotiate or modify existing mortgage loans or obtain any new mortgages;
- Ensure that all cash held by a DST may be invested only in short term debt obligations;
- Not obtain future capital contributions to the DST once the initial offering is closed;
- Not reinvest the proceeds from the sale of DST property in new investments;
- Not enter into new leases or modify existing leases except where a tenant is bankrupt or insolvent;
- Not make capital expenditures on the property other than for (a) normal repair and maintenance of the property; (b) minor non-structural capital improvements of the property; and (c) legally required repairs or improvements; and
- Distribute all net cash to beneficial owners at least quarterly.

The purpose of the seven deadly sins is to limit the trustee's ability to modify the investment. The Internal Revenue Service takes the position that passive investment in a DST restricted by the seven deadly sins is akin to ownership of property as opposed to ownership of an interest in a partnership. If a DST trustee has the power to violate any of the above rules or can change the investments of the DST, the trust will be classified as a business entity, thereby precluding the DST's beneficiaries from acquiring their interests as 1031 replacement properties. As a result, each DST structure must carefully navigate around the "seven deadly sins."

Because a DST trustee cannot renegotiate the terms of a mortgage or obtain a new mortgage, and because beneficial owners cannot make additional capital contributions to the DST, any loan on the property must have a maturity date that is later than the proposed dissolution of the DST. This will permit the trustee to sell the property before the mortgage expires. Property that is under construction or subject to a construction loan that must later be renegotiated is an inappropriate choice for 1031 DST property. A 1031 DST should also ensure that the initial investment in the DST provides for sufficient cash reserves to operate because the trustee cannot arrange for new financing or raise additional capital.

Because the Revenue Ruling restricts DSTs from renegotiating leases or entering into new leases, most DSTs hold properties with triple-net leases or enter into triple-net master leases with a DST sponsor-affiliated master tenant (an arrangement which is subject to other restrictions outside of the scope of this article). The master tenant may then enter into subleases with subtenants, thereby allowing leasing to various types of tenants, such as long-term, creditworthy tenants or tenants with short-term leasing cycles, like multi-family residential housing. When a 1031 DST is leasing property either directly to a triple-net tenant or to a triple-net tenant through a master lease, the term of the lease should extend past the proposed term of the DST so that there is ample time remaining on the lease when the property is being marketed for sale, thus attracting more buyers. Because a 1031 DST may make only specific types of improvements to the property, such as minor non-structural capital improvements and normal maintenance, DSTs typically choose to own newer properties that will not require significant repairs over the life of the DST or choose to own properties that are triple-net leased to a creditworthy tenant that is obligated to perform all maintenance and repairs.

As for distributions, the trustee of a 1031 DST must distribute net cash proceeds from the ownership of the property on a pro rata basis, meaning that there cannot be separate classes of beneficiaries or preferred interests. The trustee may not reinvest any cash, save for in short-term debt obligations. This prohibits the DST from participating in any investment other than ownership of a single property. The trustee also may not reinvest the proceeds from the sale of the DST property. Once the DST property is sold, the trustee must distribute the proceeds
from the sale of the property to the beneficial owners pursuant to their pro rata shares. Provided the DST was structurally compliant and did not commit any of the seven deadly sins, the beneficial owner would then have the right to use its share of the sale proceeds to purchase replacement property under Section 1031 and participate in another 1031 exchange.

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Alabama Updates its Unincorporated Business Entity Laws

Alabama has adopted significant amendments to its General Partnership Law, its Limited Liability Company Act, its Limited Partnership Law and its law governing Unincorporated Nonprofit Associations.

Signed by Alabama’s governor on February 22, 2018, the new laws are effective January 1, 2019.

This new legislation is set forth in H.B. 72, and has been identified as Act 2018-125.

LLCs Are Even More So Where Is The Action

Based on statistics released for the entirety of 2017 by the Kentucky Secretary of State’s office, LLCs remained the dominant entity of choice. In 2017, some 23,550 LLCs were organized in Kentucky. In turn, 2,070 for-profit corporations were organized. Essentially, more than 11 LLCs were organized for every corporation created in Kentucky.
Unlimited Liability in Limited Liability Companies

By: Vincent DiLorenzo
St. John’s University
Queens, New York

Real estate owners and developers often form limited liability companies (LLCs) to shield themselves from liability. Is this an effective means to accomplish this purpose? Curiously, the New York case law had little to say on this issue until a 2016 Second Department decision. In Board of Managers of Beacon Tower Condominium v. 85 Adams Street, the court refused to dismiss an action in common law fraud against the managing member of the sponsor LLC, as well as its principal, because the plaintiff had sufficiently pleaded they directly participated in the commission of the alleged tort.

New York Limited Liability Company Law provides that "[n]either a member, a manager nor an agent of a limited liability company ... is liable for any debts, obligations or liabilities of the limited liability company ..., whether arising in tort, contract or otherwise, solely by reason of being such member, manager or agent or acting ... in such capacities or participating ... in the conduct of the business of the limited liability company." This provision appears to provide a shield from liability, until the common law "participation" standard for individual liability for tortious conduct is considered.

The participation standard has long provided that officers and directors of a corporation are personally liable for "all torts they authorize, direct or participate, notwithstanding that they acted as agents of the corporation and not in their own behalf." The participation standard for individual liability is distinct from a standard that seeks to pierce the corporate veil.

The issue is whether members of a limited liability company that manage its affairs, as officers and directors do in a corporation, are also personally liable for all tortious acts in which they participate even when acting on behalf of the LLC. On close reading, the New York statute does not necessarily foreclose application of the participation standard by the courts, as the statute shields a member from liability arising "solely" by reason of being a member.

Case law interpreting similar limited liability company statutes in other states explored this issue earlier. The case law in other states is divided. Some states impose personal liability on members of an LLC even if they are acting on behalf of the LLC. The phrase "solely by reason" is interpreted as preventing imposition of liability based only on the status of being a member of an LLC. Others states interpret the phrase "solely by reason" as shielding members from personal liability when the actions of the member were taken in the management of the company’s affairs.

Based on the terms of the New York statute, it is not clear if the courts should impose liability when the tortious conduct occurred in the management of the LLC's business. Many state statutes stipulate only that a member is not liable "solely by reason of being a member or acting as a manager ..." The New York statute includes this language and then adds that there shall be no liability "solely by reason of participating in the conduct of the business of the limited liability company."

Appellate decisions in New York have ruled that members of an LLC that directly participate in a tort can be held individually liable. Courts have also applied that

1 136 A.D.3d 680 (2d Dep't 2016).
4 E.g., DELAWARE LIMITED LIABILITY ACT, 6 Del. C. § 18-303 (a); UNIFORM LIMITED LIABILITY COMPANY ACT § 303(a).
5 N.Y. Limited Liability Company Law § 609 (a).
All of these earlier decisions were conclusory. None of these decisions explored the meaning of “participation.” If a state applies a participation standard to hold members liable even when acting on behalf of the LLC, it must then address the issue of whether “participation” encompasses only acts of malfeasance or also encompasses acts of nonfeasance. None of these earlier decisions considered if a member can be held liable based on nonfeasance—perhaps based on knowledge of a tortious act, power to prevent the act, and a failure to do so.

In 2016, the court in *Beacon Tower* applied the participation standard in a less conclusory manner. *Beacon Tower* was an action by the board of managers of a condominium against the sponsor, which was an LLC formed solely to develop the condominium and sell the units, alleging breach of contract and fraud. Additional defendants were the managing member of the sponsor, the sole members of the managing member, which was itself an LLC, as well as the individual that was the controlling principal of the sponsor and general manager of the managing member. The court refused to dismiss the complaint against the principal and the managing member of the sponsor. The court noted that they “executed the certification page of the offering plan, and ... directly participated in the transactions at issue by virtue of their control of the sponsor. Such allegations are sufficient to support a claim that Jeshayahu and Managers participated in the commission of a tort as alleged, and that they are therefore not insulated from liability by Limited Liability Company Law §609(a) ...” However, the court did dismiss the action against the two members of the managing member because the allegation that they also participated in the transaction at issue was conclusory at best.

The court in *Beacon Tower* recognized liability based on two factual allegations: (a) execution of the certification page of the offering plan, and (b) control of the sponsor. The former has been utilized to hold the principal of the sponsor personally liable when the principal has signed the certification page in an individual capacity. The view embraced is that the certification advanced the alleged misrepresentations in the offering plan. However, in *Beacon Tower*, the managing member did not execute the certification page in an individual capacity.

The latter basis for liability, i.e., liability of a managing member by virtue of “control” of the sponsor LLC, can be interpreted as a broad viewpoint of what suffices as “participation.” The brief for defendants in the case argued against liability because “only Sponsor drafted and distributed the offering plan and entered into each Purchase Agreement with unit owners. Respondent admits that only sponsor was responsible for the marketing and distribution of the Offering Plan and the sale of the individual units.” Yet the court ruled the principal of the sponsor and the managing member could be held personally liable for their participation in the fraud “by virtue of their control of the sponsor.”

Earlier, New York appellate decisions recognizing liability based on a participation standard made it clear that the member in question committed or must commit affirmative acts that were tortious. It is not clear if the court in *Beacon Tower* intended to broaden the potential basis for liability when applying the participation standard.

It may be useful to examine case law involving corporate owners and officers, as opposed to members and principals of LLCs, to determine whether or when the participation standard allows liability based on inaction. The New York courts have made it clear that no liability is imposed on corporate officers based solely on their authority. However, corporate

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7 277 Mott Street v. Fountainhead Construction LLC, 83 A.D.3d 541 (1st Dep't 2011).
8 Id. at 682.
9 E.g., Residential Board of Managers of Zeckendorf Towers v. Union Square-14 Street Associates, 190 A.D.2d 636 (1st Dep't 1993).
12 E.g., Haire v. Bonelli, supra (members reduced or eliminated mall security to maximize profits); Rothstein v. Equity Ventures, LLC, supra (plaintiffs did not state a viable claim against two of the managing members as they failed to allege those defendants knowingly made false representations).
13 E.g. Robles v. Palazzolo Realty Corp., 66 A.D.3d 417 (1st
officers have been held liable if they are aware of the potential tort and declined to exercise their power to prevent or to remedy the wrongdoing. Thus it seems likely that Beacon Tower’s “control” language will be similarly applied to impose personal liability on principals and members of an LLC not merely based on the power to control corporate actions. Rather, what will be required is awareness of tortious activity and a failure to exercise the power to control such wrongdoing.

\[14\] E.g., American Feeds and Livestock Company, Inc. v. Kalfco, Inc., 149 A.D.2d 836 (3d Dep't 1989) (president was on notice of conversion by corporation and declined to exercise her ability to set it right); Matter of Carney's Restaurant, Inc. v. State of New York, 89 A.D.3d 1250 (3d Dep't 2011) (sole shareholder, officer and director knew of violations of Environmental Conservation Law and did not take action to remedy them).
USDA Fails to Monitor Foreign Owners of Farmland

By: Johnathan Hettinger
Midwest Center for Investigative Reporting

A law requiring foreign investors to report transactions of farmland to the U.S. Department of Agriculture has been on the books for almost 40 years.

But as the amount of foreign-controlled farmland doubled in millions of acres between 2004 and 2014, the USDA has lapsed in enforcing the law, a review of USDA documents has found.

The Agriculture Foreign Investment Disclosure Act was passed in 1978 to combat fears about increasing foreign investment in farmland.

But, since 2011, the USDA has only assessed 10 fines under the law, worth $115,724, according to records obtained by the Midwest Center for Investigative Reporting through the Freedom of Information Act. And no fines were assessed in 2015, 2016 or so far in 2017.

Lesa Johnson, the manager of the USDA program, acknowledged her office does not review the filings for completeness or accuracy. She said her office also does not investigate to see if companies with foreign ownership file these forms because of a lack of staff and resources.

Even before the recent downturn in enforcement, the USDA only assessed 187 penalties between 2004 and 2010, valued above $667,000. The largest fine of $111,266 during that time, was the result of a company self-reporting its lack of compliance with the law.

“We really can’t go after anyone,” Johnson said. “We don’t know it’s late until they call and put in a form past 90 days.”

Under the act, every foreign person or entity that acquires at least 10 percent interest in agricultural land must file what is known as an FSA-153 form. Agricultural land is defined as a parcel of land at least 10 acres in size or that could produce $1,000 in revenue from agricultural activities.

The form requires disclosure about a broad number of things, including how the project is financed, who the owner is and where the owner is from.

Penalties for not filing within 90 days can be as severe as a fine of up to 25 percent of the fair market value of the land.

Senators Chuck Grassley (R-Iowa) and Debbie Stabenow (D-Michigan) have sponsored the Food Security is National Security Act of 2017 that would strengthen the monitoring of foreign investment.

The act would give food and agriculture officials a permanent role on the federal committee in charge of reviewing foreign investment in the United States.

No progress has been made on the new act, but Grassley told the Midwest Center for Investigative Reporting through spokeswoman Jill Gerber that the “USDA should enforce the Agriculture Foreign Investment Disclosure Act.”

He said the USDA should make sure the ownership information is clear and up to date.

“Transparency adds value wherever it occurs, and analyzing trends in land ownership is helpful to understanding the current state of American agriculture. And on principle, agencies should enforce the laws on the books or ask for legislative updates if the laws are obsolete,” Grassley said. “Good government depends on good laws and the faithful execution of them.”

About 27.3 million acres of agricultural land in the United States are controlled — either owned or under a long-term lease agreement — by foreign investors, according to a USDA database of foreign investment in farmland. The land, roughly the size of Tennessee, is worth $42.7 billion.

But many of those records are incomplete and inaccurate. For example, about one million acres of land have no information about which country the owner is from. About 300,000 acres also do not list who the owner is. And typos within the data can be misleading about the true value.
In addition, spot checks by the Midwest Center of the data show that many parcels of land are no longer controlled by the owner listed in the database.

Furthermore, it is difficult to determine who owns many limited liability companies or how many companies are owned by foreign investors in whole or in part.

A self-reported mistake

Because the USDA has little capability to review filings of foreign investors, it relies on companies to report errors.

For example, in 2010, a team of attorneys at Atlanta law firm Morris, Manning & Martin realized they had failed to file a $98.9 million purchase of 55,000 acres of Alabama, Mississippi and Tennessee timberland.

The firms’ corporate and realty teams had miscommunicated, and no one had filed the FSA-153 form with the federal government, according to Rebecca Vandiver, then an attorney at the firm.

Records show the form was required because their client, RMK Select Timberland Investment Fund I, LLC, a timber investment management organization, had ownership interest from Denmark.

Vandiver said she anonymously called the federal government about the lapse, and a USDA official explained how to file and what the fine for the late filing would be.

Morris, Manning & Martin decided to voluntarily file late, which would result in an $111,266 fine, covered by malpractice insurance, rather than be in noncompliance.

But Vandiver said that it didn’t appear the federal government would have ever known the fund was in noncompliance if the firm hadn’t self-reported.

And records and comments from the USDA confirm her perception.

The RMK Select Timberland Investment Fund I fine was the largest since at least 2004, enforcement records show.

Vandiver, who also represented two other funds that were fined about $95,000 at the same time, called the penalties “draconian.”

“The government seemed to be treating this as a simple filing, so the fine was disproportionately high for missing a filing,” Vandiver said.

Vandiver, who represented many different real estate investment firms including foreign firms, said that corporate structures can often make it difficult to find out who the owner is.

“With a lot of these LLCs, finding out who the investors are would not be easy, to be honest,” Vandiver said.

Because of that difficulty, getting around the filing requirement — either by negligence or intention — would not be that hard, Vandiver said.

“If people aren’t doing the filings, the government isn’t looking into this like they should be,” Vandiver said.

Waiting for the owners

Johnson, the program manager, said that it’s likely some owners don’t file FSA 153 forms.

“It’s all based on the person coming to us,” she said. “We have no way of knowing if there is someone who is supposed to file, and they aren’t. We don’t have people out there looking.”

Penalties for late filings are only applicable to fee interest ownership, or outright ownership by the foreign entity.

But from 2004 to 2014, about 5.1 million acres were leased by foreign entities, largely foreign renewable energy companies, who lease the land for wind and solar farms. This land is valued at $8.5 billion.

Johnson said one reason the USDA has not enforced this law is because there is no penalty for late filings for the companies who lease land and who now make up such a
significant portion of the growth in foreign investment.

Johnson also said the downturn in enforcement is due to more people having knowledge of the law.

“People are filing on time and in completion,” Johnson said. “I think the word is getting out that you’re supposed to file within 90 days.”

The USDA has its county offices publish the act’s requirements a few times per year in their newsletters, Johnson said. Overall, the USDA has 4,500 locations.

They also ask county clerks and local realtors to share the information.

Most FSA-153 forms are filed with county offices and then forwarded to the USDA in Washington, D.C., though many companies with a large number of acquisitions file directly with Washington, Johnson said.

Johnson said issues with the database could be because of issues merging the data, which is stored both in Kansas City and Washington, D.C.

However, she said that much of the complete data could result from complex ownership structures.

The USDA may not know who the foreign owner is or what country they’re from because the FSA-153 form is limited to three tiers of ownership.

“I’m sure there are some that slip through the cracks,” Johnson said.

Increasing concern over foreign investors in agriculture

Foreign investment in agricultural land has been an area of concern for the past few years. In 2013, Chinese firm Shuanghui purchased U.S. pork producer Smithfield Foods for a record $4.7 billion. And this year, ChemChina, China’s state-owned chemical company, purchased Swiss agribusiness company Syngenta, one of the largest seed and crop protection companies in the world.

German company Bayer is also in the process of purchasing St. Louis-based Monsanto.

In an August policy brief, the Organization for Competitive Markets, a nonprofit organization focusing on antitrust and trade policy in agriculture, called for adoption of new legislation, as well as better enforcement of AFIDA.

“We believe foreign ownership is a national security issue and a food security issue,” said Joe Maxwell, the executive director of OCM. “We see more and more money being dumped into this sector, and it puts farmers and ranchers at an unfair competitive disadvantage. It locks out farmers, and it locks out rural communities.”

Maxwell said that foreign investment in agriculture land artificially drives up the value of land above production value, driving farmers out of the market.

Maxwell, the former lieutenant governor of Missouri, said the AFIDA database is helpful but it’s hard to make good policies when there are so many problems with the data collected.

“It’s hard to find the data,” he said. “(The database) only tells you what’s behind it, and what’s behind it isn’t that complete.”

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Single-Member Member-Managed LLC Formation . . .
Addressing the What-Ifs in Georgia or South Carolina

By: Sherri Marie Carr, Esq.
The Carr Law Firm LLC
Toccoa, Georgia

When advising clients with the formation of single-member member-managed limited liability companies (LLC) do you counsel them on or advise them to seek counsel about their estate planning documents? Should you?

Single-member member-managed limited liability companies are less complicated to form and operate than some of the other business entities available to choose from, but with the formation of this type of LLC come many perils - if the single-member member-manager becomes incapacitated or incompetent. If applicable estate planning document(s) are created in Georgia or South Carolina pertaining to the single-member member-manager then many possible worst-case scenarios can be proactively addressed to that single-member’s desires and a game plan can be put in place, especially if there is no operating agreement for the LLC.

Jurisdictions differ on some of the terminology in different estate planning documents, but a necessary estate planning document in Georgia or South Carolina that should be considered is a durable power of attorney that addresses financial and business aspects. Of course, it should be said that during the formation of the limited liability company an operating agreement should be put into place, but some single-members of member-managed limited liability companies do not want to pay for that or opt to forego that aspect of the formation process – especially if they are forming the company without the assistance of an attorney. This stresses the importance of having a discussion about the “what-ifs” that could happen as a single-member of a member-managed LLC.

These two documents (a durable power of attorney that addresses financial and business aspects and an operating agreement) in conjunction will allow the single-member to have control over what happens to the single-member member-managed LLC even if the single member becomes incapacitated or incompetent. At a minimum, if the single-member does not have an operating agreement because they feel they are the only one involved in the business or for whatever reason they should have a durable power of attorney put in place that addresses the financial and business aspects involved. Why a durable power of attorney? Because if you are addressing the what-ifs of incapacity or incompetency a durable power of attorney applies; durable powers of attorney apply even if your client becomes incapacitated.

The Operating Agreement indicates what should be done to a single-member member-managed limited liability company, even if the single-member is incapacitated or incompetent. If there is no Operating Agreement in place the person you designate in your durable power of attorney dealing with financial and business interests would may have no guidance as to the single-member’s wishes regarding what happens to their business and could make decisions for the applicable business that are against the single-member’s ultimate wishes. In South Carolina, section 62-8-209 of the Uniform Power of Attorney Act governs subject to an applicable operating agreement and any limitations put into an applicable power of attorney. In Georgia, section 10-6B-48 of the Georgia Code governs subject to an applicable operating agreement and any limitations put into an applicable power of attorney. Both South Carolina and Georgia’s governing sections allow for the same things: in what they would allow someone to do on behalf of a principal under a power of attorney regarding the operation of a business entity.

Of course, I understand that no one wants to think about the worst-case scenarios that could happen, but if you are forming a single-member member-managed limited liability company for a client in Georgia or South Carolina, I highly recommend addressing at the formation stage the need for an operating agreement in conjunction with a durable power of attorney that addresses business and financial aspects.
Court Rules LLC Members May Be “Fiduciaries In Fact”

By: Keith Paul Bishop
Allen Matkins Leck Gamble Mallory & Natsis LLP
Irvine, California

U.S. District Court Judge Tena Campbell’s ruling in Strong v. Cochran, 1 is a reminder that sometimes what you do matters more than what you say. The case involved claims by the liquidating trustee for a failed real estate firm, Castle Arch Real Estate Investment Company, LLC, a California limited liability company (“CAREIC”). The trustee sued the members of CAREIC for among other things, breach of fiduciary duty. The members moved to dismiss that claim on the basis that “Amended Complaint does not allege the existence of a fiduciary duty, much less the breach of any such duty”.

Judge Campbell rejected the defendants’ motion with the following explanation (footnote omitted):

California courts have applied such a “fiduciary duty in fact” concept. Under that approach, an individual, regardless of title, owes a fiduciary duty to a company when the individual “participates in management of the corporation” and “exercis[es] some discretionary authority.” 2

While a limited partner normally would not be involved in the management or otherwise participate in the partnership . . . so as to incur fiduciary obligations to other partners, we believe there can be factual scenarios where a limited partner might be involved in the partnership in such a manner . . . so as to create fiduciary duties. 3

The Trustee rightfully insists that “[t]he Moving Defendants cannot hide behind the CAREIC Operating Agreement to claim that they did not owe a fiduciary duty to CAREIC or its investors. The realities of how a company is operated govern rather than its formal structure.” 4 The Amended Complaint alleges actual circumstances, not typical circumstances, and that is adequate under California law.

While it remains to be seen whether the liquidating trustee can prove his allegations, the case is a reminder that member involvement in the management of manager-managed LLCs can be perilous.

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1 2017 U.S. Dist. LEXIS 170073.
3 Tri-Growth Centre City, Ltd. v. Silldorf, Burdman, Duignan & Eisenberg, 216 Cal. App. 3d 1139, 265 Cal. Rptr. 330, 335 (Cal. Ct. App. 1989) (emphasis added) (leaving for resolution at trial the factual issue of whether a fiduciary duty in fact existed); see also Mission W. Props., L.P. v. Republic Props. Corp., 197 Cal. App. 4th 707, 129 Cal. Rptr. 3d 14, 22 n.8 (Cal. Ct. App. 2011) (holding that notwithstanding the California statutory law and the limited partnership agreement, a limited partner may have a fiduciary duty if he engages in management of the company) (citing Tri-Growth).

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4 Combined Opp’n at 12, ECF No. 126.
Pennsylvania Supreme Court Issues a Truly Bizarre Opinion on the Obligation of Good Faith and Fair Dealing in Limited Partnership Agreements

By: Thomas E. Rutledge
Stoll Keenon Ogden PLLC
Louisville, Kentucky

Within every contract there exist a non-waivable obligation of good faith and fair dealing. If you don’t believe me, believe the Restatement (2nd) of Contracts, which at section 205 provides:

Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement.

That said, in a recent, and fairly described as truly bizarre, decision from the Pennsylvania Supreme Court, Hanaway v. Parkersburg Group, it held that no obligation of good faith and fair dealing arose in an agreement of limited partnership.1

The Hanaways, plaintiffs in this action, were among the limited partners of Sadsbury Associates, L.P., a Pennsylvania limited partnership of which T. R. White, Inc. (“White”) served as the general partner. The Sadsbury limited partnership was a financial success. In light of that history, the same participants organized the Parkersburg limited partnership, largely devoted to the organization of a housing development. There was transferred to Parkersburg an option owned by White for what was referred to as the “Davis Tract.” The subdivision plat as well included an adjacent quarry, owned by the Hanaways and for which Parkersburg held an option. The agreement of limited partnership gave White broad discretion with respect to its management and as well imposed ongoing capital contribution obligations upon the limited partners.

Sometime after Parkersburg began the planning effort with respect to the subdivision, the Hanaways advised Parkersburg that the option to acquire the quarry had expired and would not be renewed, and as well that they refused to contribute additional capital to the project. These actions by the Hanaways led other limited partners to be unwilling to contribute additional capital, and the project stalled. White informed the Hanaways that the Davis Tract would be sold, as well as the option for an adjacent tract upon which an option was held, for appraised fair market value to a newly formed limited partnership, Park Mansion Partners (“PMP”). White served as the general partner of PMP, and its limited partners were those persons who had been limited partners in Parkersburg, with the exception of the Hanaways. Some two years later, the Hanaways would file suit, alleging the sale of the properties to PMP for less than adequate consideration and below fair market value, all “as part of the scheme to eliminate the Hanaways’ ownership interests.”2 In response to a motion for partial summary judgment based upon the failure by the Hanaways to identify a specific term of the Parkersburg limited partnership agreement that had been breached, they contended that White had breached the implied covenant of good faith and fair dealing. The trial court granted partial summary judgment, holding, inter alia, that the broad discretion afforded White in the agreement of limited partnership could not be overridden by the implied covenant of good faith and fair dealing. An intermediate court of appeals would reverse, holding that the discharge of the contractually granted rights remained subject to the implied covenant of good faith and fair dealing, and on that basis reversed the trial court.3 In doing so, that intermediate court of appeals both adopted the Restatement (2nd) of Contracts section 205 and, as characterized by the Pennsylvania Supreme Court:

Perceived no reason to treat limited partnership agreements differently than any other type of contract. The majority also opined that the Hanaway’s breach of the covenant of good faith and fair dealing claim was a breach of contract action, not an independent action for breach of a duty of good faith. 2017 WL 3600580, *3.

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The Pennsylvania Supreme Court would reverse that determination, holding in effect that the obligation of good faith and fair dealing does not apply and limited partnership agreements save those organized under Pennsylvania’s new (2016) Limited Partnership Act, it expressly providing for the obligation of good faith and fair dealing. There is underlying political aspect of this determination. At the intermediate court of appeals, then Judge Donahue, since transitioned to the Pennsylvania Supreme Court, had in a dissenting opinion stated that the implied covenant of good faith and fair dealing does not apply in limited partnerships because they are “creatures of the legislature.” That are “governed, first and foremost” by the Limited Partnership Act. This decision of the Pennsylvania Supreme Court would for all interests and purposes adopt that dissent.

As described by the Pennsylvania Supreme Court:

We granted allocatur to consider whether the implied covenant of good faith and fair dealing applies to all limited partnership agreements formed in Pennsylvania, and, if so, whether the implied duty of good faith and prayer dealing can override the express terms of a limited partnership agreement. 2017 WL 3600580, *4.

In response thereto, White adopted the reasoning espoused by Donahue at the intermediate appellate level, “emphasizing that limited partnership agreements are unique and ill-suited for application of the implied covenant of good faith and fair dealing because they are governed by statute.” He pointed out as well that under the Uniform Limited Partnership Act (2001), adopted in Pennsylvania in 2016, there is an express incorporation into the statute of the contractual obligation of good faith and fair dealing, characterizing this as a “drastic change” and reasoning that the obligation of good faith and fair dealing “did not exist at the time that the parties formed Parkburg and entered into a limited partnership agreement.” In contrast, the Hanaways argued that the implied covenant applies in all contracts, including limited partnership agreements.

IMHO, the Pennsylvania Supreme Court could have easily resolved this dispute without making any further examination of the obligation of good faith and fair dealing. Specifically, it could have held, as a factual matter, that the actions undertaken by White in the reorganization of the then failing Parksburg limited partnership fell within the general partners authority and/or that the plaintiffs had failed to adequately plead how White’s actions constituted a breach of the limited partnership agreement. Had the court done so, the Hanaway opinion would have been entirely uninteresting. Unfortunately, that is not the way it went down.

The Pennsylvania Supreme Court would hold that, except with respect to limited partnerships organized under the Uniform Limited Partnership Act as adopted in Pennsylvania in 2016, the implied covenant of good faith and prayer dealing does not apply with respect to limited partnership agreements. After stating that “The Hanaways had the opportunity to bargain for specific protections without having to rely upon implicit concepts,” a statement that can only be made if one entirely ignores the purpose of the implied covenant, the court went on to hold that, under the applicable Limited Partnership Act “there was no duty of good faith applicable to limited partnership agreements formed pursuant to PRULPA.”

This decision was joined in by three members of the six person court. Justice Donahue, who participated in the decision at the intermediate appellate level, did not participate. There was a dissenting opinion by two of the sitting justices, an opinion which would have found that the contractual obligation of good faith and fair dealing applies to any contract, and that the failure to reference the obligation in the prior limited partnership act in no manner abrogated its existence. From there, the dissent would have suggested a focus upon “whether

6 Id.

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5 2017 WL 3600580 *5.
the implied covenant of good faith and fair dealing may impose duties that are inconsistent with the duties imposed by the express terms of a limited partnership agreement,” suggesting that:

It is illogical to conclude that, had the limited partners considered this issue at the time of forming the limited partnership, the limited partners would have authorized Parksburg (sic - White), as the general partner, to exercise its discretion in bad faith to the detriment of either the Partnership or the limited partners.

This is, at minimum, a disturbing decision. First, for a state supreme court to suggest that because limited partnership agreements are created pursuant to statute that the obligation of good faith and fair dealing is somehow inapplicable is simply nonsensical. Under that paradigm, to what degree of statutory involvement is necessary in order to abrogate the application of section 205 of the Restatement (2nd) of Contracts and the implied covenant? Partnership agreements are heavily influenced by statute. LLC operating agreements are heavily influenced by statute. Stockholder buy/sale-restriction agreements are heavily influenced by statute. Security agreements are heavily influenced by statute. The list goes on. Is the implied covenant inapplicable in all of them?

At least one member of the Pennsylvania bar has suggested that this decision is not that important because, with the application of the new Pennsylvania limited partnership act to existing limited partnerships, they will all become subject to the new law’s express incorporation of the implied covenant of good faith and fair dealing. I can’t accept that. First, with respect to all of those legacy limited partnerships, the implied covenant of good faith and fair dealing will not apply retroactively to conduct and actions that accrued prior to the drag-in effective date. Second, only a minority of the states have adopted the Uniform Limited Partnership Act (2001). Litigants in other states, seeking to avoid the application of the implied covenant of good faith and fair dealing, are going to cite this decision of the Pennsylvania Supreme Court in support of the notion that the covenant is somehow inapplicable. Hopefully those foreign courts will undertake an appropriate analysis and an appreciation that the implied covenant exist in every contract, and its reference in the Uniform Limited Partnership Act (2001) is primarily in order to make clear that it cannot be waived in an agreement, but the terms of its application may be explained.

All in all, this is just a bizarre decision.
Obsolete Tax "Boilerplate" in Partnership and Operating Agreements

Most partnership and operating agreements contain a provision to the effect that no transfer of an interest will be permitted or recognized if it would cause a “Code § 708 termination” of the (for tax purposes) partnership. More sophisticated agreements might as well contain a provision addressing how a “Section 708 termination” will be addressed. A provision of this nature might read:

Notwithstanding any other provision of this Article __, in the event that the Company is liquidated within the meaning of Regulation § 1.704-1(b)(2)(ii)(g), but no dissolution event has otherwise taken place, the assets of the Company will not be liquidated, the debts and other liabilities of the Company will not be paid or discharged, and the business and affairs of the Company shall not be wound up. Instead, solely for federal income tax purposes, the Company shall be deemed to have contributed all of its property, assets and liabilities to a new limited liability company in exchange for an interest in such new limited liability company and, immediately thereafter, the Company will be deemed to liquidate by distributing interest in that new limited liability company to the members of this Company. Said new limited liability company shall be bound by this Agreement. It is understood that the provisions of this § ____ are set forth herein exclusively to government federal income tax treatment and to have no other force or effect.

The import of these provisions was to address Code § 708(b)(1)(B), which provided that a partnership would be terminated if in any 12 month period there were sales or exchanges of 50% or more of the interests in the partnership's capital and profits. The effects of the termination, especially one not recognized at the time, could be significant, including short year reporting, the resetting of depreciation timelines, income bunching in a short year and the need to make anew various tax elections.

Which was all well and good until December 22, 2017 and the recent amendments to the tax code. One of those amendments deleted Code § 708(b)(1)(B). In consequence, provisions in partnership and operating agreements limiting transfers that would precipitate a technical termination may now be deleted.

That said, not all of Code § 708 has been deleted, and a partnership will be considered to have terminated “only if no part of any business, financial operation, or venture of the partnership continues to be carried on in a partnership.” The effect of eliminating technical terminations is to limit the application of the rules on terminations to those situations in which the partnership has truly ceased to carry on a business or activity through disposition of the business or the completion of winding up. The rules governing mergers and divisions are apparently unaffected by this change.


Bahar A. Schippel, *To Be or Not To Be, a C Corporation*, 21 J. PASSTHROUGH ENTITIES 69 (March/April 2018).
PLANNING AHEAD

The Committee on LLCs, Partnerships and Unincorporated Entities will meet three times in 2018: at the Spring Meeting of the Section on Business Law, at the Annual Meeting of the Section of Business Law, and at the 2018 LLC Institute. Looking forward:

<table>
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<th>Event</th>
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<tr>
<td>2018 ABA BLS Annual Meeting</td>
<td>August 2-7, 2018</td>
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<tr>
<td>Austin, Texas</td>
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<tr>
<td>2018 LLC Institute</td>
<td>October 11-12, 2018</td>
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<tr>
<td>Washington, DC</td>
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<td>2019 ABA BLS Spring Meeting</td>
<td>March 28-30, 2019</td>
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<tr>
<td>Vancouver, BC</td>
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<td>2019 ABA BLS Annual Meeting</td>
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<td>Washington, DC</td>
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<td>2019 LLC Institute</td>
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The detailed schedules for Committee meetings and programs at these meetings will be announced in future issues of the LLC & Partnership Reporter.
Fundamental Principles to be Considered in any New Federal Legislation Requiring the Disclosure of Beneficial Ownership Information by U.S. Entities

Preamble

The Corporate Laws Committee of the Business Law Section of the American Bar Association (the “Corporate Laws Committee”) has prepared this outline to recommend fundamental principles that should be considered in any new Federal legislation requiring the disclosure of beneficial ownership information by U.S. entities. The Committee recognizes that any such legislation will continue to be the subject of significant debate among many constituencies. We have prepared this recommendation with the goal of making the information and views set forth below part of that debate.¹

Recommendation

In considering legislation requiring disclosure of beneficial ownership information of U.S. entities (i.e., certain identifying and personal information of the individuals who directly or indirectly own and/or control U.S. entities), the Committee recommends that the American Bar Association adopt a policy that certain fundamental principles should be considered, including:

- legitimate confidentiality interests should be protected, and, at the same time, law enforcement has a bona fide interest in having prompt access to beneficial ownership information;
- the definition of and reporting threshold for beneficial ownership should be clear and reasonable;
- the reporting of beneficial ownership information should be an entity obligation;
- any legislation must address all types of entity structures;² and
- penalties for noncompliance should be calibrated to the nature of the noncompliance.

As described below, American Bar Association policy should support the consideration of new Federal legislation, based on these fundamental principles, to provide for the collection and disclosure of beneficial ownership information by U.S. entities. That legislation could either implement a Federal system or mandate that states implement a system, in either case providing for the collection of information for U.S. entities, and in each case providing that a designated records contact who is a U.S. citizen maintain beneficial ownership information that would be made available to specified recipients upon a proper showing. Enforcement of noncompliance could include a combination of Federal and state penalties.

¹ There is currently no provision in the Model Business Corporation Act (the “MBCA”) for collecting and maintaining beneficial ownership information of corporations. The Corporate Laws Committee previously considered but did not adopt possible amendments to the MBCA that, among other matters, would have permitted the secretary of state to dissolve a designated corporation administratively if the corporation did not designate an individual with access to the corporation's beneficial ownership information or did not keep the information up to date.

² As described below, the number of alternative entities, especially limited liability companies, formed in the United States each year substantially outpaces the number of corporations formed.
Supporting Report

Summary of Previous U.S. Proposals and Existing International Requirements

As a preliminary matter, previous proposals for legislation considered in the United States and existing international requirements for reporting beneficial ownership information provide important context to the fundamental principles highlighted above and discussed below. Those legislative proposals and existing international requirements are summarized here.

Uniform Law Enforcement Access to Entity Information Act (2009)

- The Uniform Law Enforcement Access to Entity Information Act (the “ULEAEIA”) was drafted in 2009 by the Uniform Law Commission at the request of the National Association of Secretaries of State.
- The ULEAEIA provides a single statute that can be enacted by states to address the issues regarding availability of beneficial ownership information raised by the Financial Action Task Force (“FATF”) in its recommendations, which include a recommendation that countries “ensure that there is adequate, accurate and timely information on beneficial ownership and control of legal persons that can be obtained or accessed in a timely fashion by competent authorities.”
- The Corporate Laws Committee was represented on the drafting committee of the ULEAEIA and reviewed the ULEAEIA, and under the Uniform Laws Commission process, the views of the American Bar Association were formally solicited, and the House of Delegates of the American Bar Association approved a resolution supporting the ULEAEIA.
- The ULEAEIA has not been adopted by any state.
- The ULEAEIA requires each entity organized under the laws of a state to provide an entity information statement to the secretary of state of that state.
  - Entities subject to the ULEAEIA would include corporations, limited liability companies, limited partnerships, cooperative associations, statutory trusts and any other entities authorized by the laws of the state.
  - The entity information statement would include the name and address of a records contact of the entity.
- The duties of the records contact would include requesting from the entity its “beneficial ownership and control information” for each interest holder upon an appropriate request from a competent authority.
  - “Beneficial ownership” information would have included holders of record and not the beneficial owners of the holders of record of the entity.
  - An entity does not have a duty under the ULEAEIA to inquire as to who are the beneficial owners of the interests in the entity held by its interest holders of record.
- If an entity failed to materially comply with the ULEAEIA, the attorney general of the state could commence a proceeding to dissolve the entity.
- The ULEAEIA stated that the records contact would not be liable for providing information or for an inaccuracy in or omission from the information provided, except for liability for recklessness, intentional misconduct or criminal conduct.


- European Union (“EU”) Member States are required to maintain a central register of beneficial ownership information for corporate and other legal entities.
- Required access to the register is given only to government authorities, financial institutions within the framework of customer due diligence, and any persons or organization that can demonstrate a legitimate interest with respect to money laundering, terrorist financing, corruption, tax crimes or fraud.

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3 The Financial Action Task Force is an inter-governmental body established in 1989 with the objective of setting standards and promoting effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system.
Under the EU’s Fourth Anti-Money Laundering Directive, the EU Member States may, in exceptional cases, deny access to the central register where such access would expose the beneficial owner to the risk of fraud, kidnapping, blackmail, violence or intimidation, or where the beneficial owner is a minor or otherwise incapable.

United Kingdom’s Register of People with Significant Control (“PSC”) Regulations Adopted in Response to the EU’s Anti-Money Laundering Directive (2016)

- In response to the EU’s Anti-Money Laundering Directive, the United Kingdom has adopted a national legislative framework for reporting beneficial ownership of companies and similar entities.
- All companies and similar entities, other than publicly traded entities, are required to maintain a registry of persons identified as controlling persons and provide the information on the registry to Companies House.
- Anyone may have access to the full registry, or obtain a copy of it upon payment of a nominal fee, by making written request stating their name, address and purpose for seeking the information.
- Under the UK regime, special rules apply to the disclosure and publication of residential addresses and dates of birth, and the public information that is extracted from the registry and disclosed on the Companies House website is a subset of the information maintained on the company’s registry.
- Failure to comply with the requirements of the UK PSC regime is a criminal offense and the entity and its directors may face fines, imprisonment or both.
  - Recognizing that entities may not always have the information required to comply with the PSC regime, the UK regulations require that notice be provided on anyone believed to have information that will help identify the PSCs.
  - Failure to respond to this notice is also a criminal offense.
  - Moreover, an individual or legal entity’s failure to respond to a company’s enquiries about registering gives the company the ability (without a court order) to impose restrictions on any shares held by them.  


- Amends the Bank Secrecy Act to provide that the “Secretary may require any United States entity to maintain records and file reports on the beneficial owners of such entity.”
- A “United States entity” includes any entity that uses “any facility in interstate or foreign commerce . . . in its business activity.”
- Beneficial ownership is to be defined by the U.S. Treasury.
- Does not include provisions relating to the confidentiality of information that is reported.
- Contemplates civil penalties only (no criminal penalties).


- Introduced in the U.S. Senate in July 2016 and not re-introduced in the latest Congressional session.
- Amends the Internal Revenue Code to require that every “United States entity” obtain and have an employer identification number, or EIN.
- A United States entity is “any business entity created or organized in the United States or under the law of the United States or a State, possession, or territory of the United States” other than exempt organizations under Section 501(a) of the Internal Revenue Code.
- Provides that certain taxpayer identification information may be disclosed to Federal law enforcement agencies for use in anti-money laundering and counterterrorism prosecutions and investigations.
- In addition to civil penalties, includes criminal penalties for “willful” violations.

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4 Under the UK PSC regime, a company may note on its PSC registry that a restriction has been issued on the shares. While that restriction is in place, neither the shares nor any interest in the shares can be transferred or sold and no payments can be received in respect of the shares. A company may also apply to a court to sell or transfer the restricted shares.
FinCEN Geographic Targeting Order (2016)

- Intended to carry out the purposes of the Bank Secrecy Act.
- Requires title insurance companies to collect and report beneficial ownership information of entities purchasing residential real property in identified markets (i.e., New York City, Southern Florida, California, Honolulu and San Antonio) if the purchase is made without a bank loan or other similar financing.
  - The title insurance company also must collect information (driver’s license, passport or similar identifying information) about the individual “primarily responsible for representing the purchaser.”
- “Beneficial owner” is narrowly defined to mean “each individual who, directly or indirectly, owns 25% or more of the equity interests of the Purchaser.”
  - If the purchaser is a limited liability company, the name, address and taxpayer identification number of all of its members must be reported.
- The title insurance company may be liable for civil or criminal penalties for violating the order.

Counter Terrorism and Illicit Finance Act (2017)

- A joint hearing to discuss this legislative proposal was held by the Financial Institutions and Consumer Credit and the Terrorism and Illicit Finance subcommittees of the House of Representatives in November 2017.
- Contemplates Federal reporting of beneficial ownership information to the Financial Crimes Enforcement Network (“FinCEN”) bureau of the United States Department of the Treasury (the “U.S. Treasury”).
- The definition of beneficial ownership is broad and vague:
  - As defined, beneficial owner includes any natural person who directly or indirectly (a) “exercises substantial control over”, (b) owns 25% or more of the equity interests of” or (c) “receives substantial economic benefits from the assets” of a corporation or limited liability company.
  - Minor children, creditors, and persons acting solely as employees are excluded from the definition of beneficial owner.
- Imposes the initial obligation to provide beneficial ownership information on “each applicant to form a corporation or limited liability company” and penalizes applicants for “knowingly” providing false or fraudulent beneficial ownership information or “willingly” failing to provide complete beneficial ownership information.
- Requires that the corporation or limited liability company update the beneficial ownership information within 60 days after any change in the information provided and otherwise annually.
- Various corporations and limited liability companies are excluded from the reporting requirements, including most significantly:
  - An issuer of a class of securities registered under the Securities Exchange Act of 1934 (the “Exchange Act”) or an entity that is required to file reports under the Exchange Act;
  - Regulated entities, including banks, bank holding companies, broker-dealers, insurance companies and public utilities;
  - An entity with (i) 20 or more full-time employees, (ii) over $5 million in “gross receipts” or sales and (iii) “an operating presence at a physical office within the United States”;
  - A corporation or limited liability company that is “formed and owned by an entity” that is not required to be subject to the reporting requirements.
- Beneficial ownership information is to be provided in response to:
  - a criminal subpoena from a Federal agency;
  - a request made by a Federal agency on behalf of a law enforcement agency of another country (provided that such other country agrees to prevent the public disclosure of such beneficial ownership information or use it for another purpose); or
Legitimate Confidentiality Interests Should be Protected, and, at the Same Time, Law Enforcement Has a Bona Fide Interest in Having Prompt Access to Beneficial Ownership Information

1. There are numerous valid interests in maintaining the confidentiality of beneficial ownership information, including:
   - Personal and data privacy represent valid interests entitled to recognition.
   - Public disclosure could create public safety issues for elected officials, judges, public figures and vulnerable individuals, such as seniors and minors.
   - Public disclosure creates an increased risk of identity theft or fraud.
   - Philanthropic donors and donees have a legitimate interest in confidentiality.
   - Legitimate commercial business interests, such as property acquisition, are also valid interests to protect with confidentiality.

2. At the same time, law enforcement has a bona fide interest in having prompt access to beneficial ownership information.
   - Access to beneficial ownership information is critical to permit law enforcement to pursue money laundering, tax evasion and terrorist financing.
   - A proper showing (i.e., a subpoena or warrant) validates the propriety of the request for law enforcement to gain access to beneficial ownership information.
   - Although the goal of beneficial ownership reporting legislation should be to permit law enforcement to pursue money laundering, tax evasion and terrorist financing, financial institutions are subject to due diligence requirements under Federal and state law that require them to collect the same (and in many cases more) information.
   - Federal legislation could permit the beneficial ownership information to be made available to a financial institution upon a request made by a financial institution, with customer consent, as part of the institution’s compliance with applicable Federal or state law, provided that such financial institution agrees to prevent the public disclosure of such beneficial ownership information or use it for another purpose.

3. Beneficial ownership information can be collected and maintained confidentially by entities and reported without impinging upon the valid confidentiality interests. However, reporting of beneficial ownership information will be subject to possible loss of confidentiality unless there are compensating protections.
   - Reporting beneficial ownership information on a Federal or state level exposes that information to possible confidentiality breaches.
     - Confidentiality may be compromised if beneficial ownership information is shared among government entities or used by financial institutions for unrelated purposes and may be further compromised if information is shared with foreign authorities in the context of international investigations.
     - Confidentiality and data breaches may be inevitable and expose beneficial owners to the risk of identity theft or fraud.\(^5\)
     - Freedom of Information Act (“FOIA”) access is particularly problematic at the state level where application and process is inconsistent.

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\(^5\) A recent report by the Treasury Inspector General for Tax Administration found that half of the Internal Revenue Service (“IRS”) employees in a sample e-mailed personally identifiable information from tax returns in violation of IRS policy, including to external non-IRS e-mail accounts. In 2015, the IRS was reportedly subject to a cyber-attack in which hackers gained access to personal data from more than 700,000 taxpayer accounts.
4. The information required (e.g., a passport, driver’s license or government issued photo identification document for each individual resident outside the United States) should be limited only to information directly related to the specific objective.

- Collection of personal data should be limited in order to reduce the potential damage resulting from identity theft or fraud in the event of a data breach.
- In jurisdictions with public ownership registers (such as the United Kingdom), beneficial owners are provided advance notice of the public disclosure of their personal information. That advance notice should not be necessary if information is held confidentially and used only to directly satisfy objectives.

5. While the law enforcement need is compelling and financial institutions’ compliance obligations are critical in supporting law enforcement, the public does not have a need to have access to the beneficial ownership information beyond the fiduciary information (i.e., names and business addresses of directors and principal officers) that is already reported to the state secretaries of state.

- Most states currently require annual reporting of fiduciaries, including board members of a corporation and the managers, members or partners who constitute the equivalent in other forms of entities.
- Beneficial ownership reporting should supplement, and not displace, fiduciary reporting.
- Fiduciary reporting should focus on identifying fiduciaries who are natural persons, giving law enforcement a human point of contact.
- Public access to beneficial ownership information could have a negative impact on legitimate commercial business interests.
  - Competitors, investors, suppliers or consumers may not, for various reasons, wish to do business with a certain company because of its beneficial owners or the information may disproportionately influence prices and other business terms.
- Public access to beneficial ownership information may compromise employee confidentiality in situations where equity interests are given as compensation.
- If information is collected and maintained confidentially and tailored for the purpose to be achieved (i.e., pursuing money laundering, tax evasion and terrorist financing after a proper showing), better compliance should be achieved. If the information is not confidential or is sought for other interests, entities may consider the risk of penalties for non-compliance to be one worth taking.

6. Consistent with limiting access to beneficial ownership information to that necessary to achieve specific law enforcement and financial institution compliance objectives, beneficial ownership information should be excluded from state law inspection rights of information held by the business entity and statutory provisions providing for interrogatories by a secretary of state.

7. If, despite the points set forth above, persons other than law enforcement and financial institutions are granted access to information on beneficial ownership, that access should be limited to situations where a compelling need for the information is demonstrated and should be subject to judicial oversight.

- In many states, state law has a framework with procedural safeguards for granting inspection rights of information on ownership held by the business entity. If persons or entities other than law enforcement and financial institutions are granted access to information on beneficial ownership, a similar framework should be adopted to ensure that a compelling need for the information is demonstrated before disclosure occurs.
  - For example, the process should ensure that the beneficial ownership information is not being used for political or private litigation purposes.
- In addition, where there is a serious risk that such information could be used for intimidation or violence, a provision for suppressing information relating to beneficial ownership should be available.
1. The definition of beneficial ownership used in reporting beneficial ownership information must be clear enough so that entities can determine what information to collect and report. Previous U.S. proposals have included a vague and broad definition of beneficial ownership (the Counter Terrorism and Illicit Finance Act) or deferred to U.S. Treasury rulemaking to define beneficial ownership (the U.S. Treasury Proposal).
   - If the definition is overbroad, entities will be subject to undue delay and expense in determining how to properly comply with expansive requirements.
   - Alternatively, entities may decide that overbroad reporting requirements are simply not worth complying with at all.
   - While large corporations may have the ability to bear the costs of compliance, the majority of U.S. entities are small businesses or single purpose entities where the costs of gathering and maintaining information would be burdensome.
   - The FinCEN Geographic Targeting Order has a specific definition of beneficial ownership ("each individual who, directly or indirectly, owns 25% or more of the equity interests of the Purchaser") that is tied only to equity ownership (the "ownership prong"), with no language about identifying others who lack ownership but still control the entity (the separate "control prong").

2. The FATF definition of beneficial ownership has been applied in many jurisdictions, and there is experience in interpreting it in those jurisdictions. Under the FATF definition, the beneficial owner test includes both an ownership and a control prong and refers to the natural person(s) who ultimately own or control an entity and/or "the natural person on whose behalf a transaction is being conducted."
   - Under the FATF definition, the beneficial owner also includes those natural persons who exercise ultimate effective control over a legal person or arrangement.

3. The UK PSC definition of beneficial ownership also has an ownership prong (more than 25%) and a control prong by including an individual "having the right to exercise or actually exercising, significant influence or control" of the entity.

4. The thresholds for beneficial ownership disclosure should be set in a manner (e.g., within the ownership prong, ownership or voting of 25% or more) that satisfies the needs of law enforcement while not imposing an unnecessary burden on U.S. entities in light of the objective of beneficial ownership reporting.
   - The UK and FATF use a “more than 25%” ownership threshold.

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6 The U.S. securities laws also have a definition of beneficial ownership that is well understood. Under the U.S. securities laws, a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares (1) voting power (which includes the power to vote, or to direct the voting of, such security) and/or (2) investment power (which includes the power to dispose, or to direct the disposition of, such security). In applying that definition for beneficial ownership reporting for public companies, the SEC frequently tells registrants to disclose the natural person or persons who control the voting or dispositive power over the securities held.

7 UK statutory guidance for limited liability partnerships (LLPs) provides that significant influence or control may be present where an individual is likely to receive more than 25% of the profits of the LLP, even if that person is not a member.

8 The Hong Kong Government recently made a proposal to expand its AML laws. The proposal includes a definition of “beneficial owner” as any individual meeting at least one of the following conditions (i) directly or indirectly holding more than 25% of shares, (ii) directly or indirectly holding more than 25% of voting rights, (iii) directly or indirectly holding the right to appoint or remove a majority of directors; (iv) otherwise having the right to exercise, or actually exercising, significant influence or control; or (v) having the right to exercise, or actually exercising, significant influence or control over the activities of a trust or a firm that is not a legal person, but whose trustees or members satisfy any of the first four conditions (in their capacity as such) in relation to the company, or would do so if they were individuals.
5. The beneficial ownership reporting regime should strike the balance between the benefits of having access to beneficial ownership information and the burdens on governments in collecting that information and on business entities in complying.

- The reality is that fraud and corruption targeted by disclosure of the beneficial ownership is concentrated in closely-held entities, not those that are owned by many stock or interest-holders.
- Individuals who have assets to shelter, income to hide from tax authorities, or other improper motives do not band together to form broadly-held entities in which others invest.
- Instead, individuals and organizations engaged in fraud, corruption or terrorist financing tend to set up entities that they control through other entities they control or front-people who they control.
- For that reason, the focus of any cost-effective disclosure regime should be on these closely-held entities, and understanding who owns and controls them.
- Spending to collect information that has no rational connection to the source of the fraud, tax evasion, and other illegal conduct that is a legitimate concern of law enforcement wastes public resources, detracts from economic growth, and engenders skepticism about whether government is regulating wisely in the public interest.
- If a strong disclosure regime is put in place that focuses on the closely-held entities that are the vehicles through which illegal conduct of the kind that is at issue is conducted, then law enforcement should benefit because the regulators charged with making sure that disclosure regime is honored will be better positioned to do it well and make sure that the information law enforcement needs is kept current and is available when needed.

6. The objective of beneficial ownership reporting should be to identify at least one natural person.

- The initial point of inquiry should be a direct or indirect ownership inquiry, such as the FATF definition under which reporting is required for any natural person with ownership or voting rights greater than 25%.
  - Such a definition is consistent with the definition of beneficial ownership used in the FinCEN Geographic Targeting Order.
- If the initial point of inquiry does not yield the identity of a natural person, a second point of inquiry could look to a control prong and identify the natural person who exercises ultimate effective control over the entity, which would include a fiduciary of the entity.

7. The reporting of beneficial ownership information should be an entity obligation.

- Because applicants to form an entity may not have the ongoing access to information that the entity itself does, applicants should not be relied upon to report beneficial ownership information.

8. The ownership and control prongs should incorporate a “group” concept – i.e. beneficial owners acting in concert, which would include any form of agreement to exercise their ownership rights to effect control between individuals whether written or verbal, should be aggregated in assessing their collective ownership against the threshold or their collective control.
Any Legislation Must Address All Types of Entity Structures

1. It is critical that the same reporting standards be imposed on all entities.
   
   - No system of reporting beneficial ownership information would be effective if it does not cover all forms of entities as that would create a loophole that could be easily exploited.
   - The corporate law in most states mandates fiduciary reporting and can provide one source of information for law enforcement pursuing money laundering, tax evasion and terrorist financing.
     - Natural persons serve as incorporators and directors of corporate entities.
     - State law generally requires annual reporting of the names of these individuals to a state secretary of state or similar governmental entity regulating corporations.
   - Similar reporting requirements, however, often do not apply to limited liability companies, limited partnerships, partnerships and other alternative entities. As a result, reports by these entities to a secretary of state or other regulatory entity do not necessarily identify a natural person.
     - Limited liability companies may have no natural persons as officers or managers.
     - Limited partnerships often have no natural person partners.
     - In many jurisdictions, general partnerships are not required to make any filings.
   - The formation of alternative entities outpaces the formation of corporations by at least three to one.
     - In Delaware, of 190,000 new business entities formed in 2016, 137,000 (72%) were LLCs, 40,000 (21%) were corporations, 11,000 (6%) were LPs/LLPs and 1,400 (1%) were statutory trusts.
     - In Pennsylvania and Maryland, the 2016 figures are even more skewed towards LLCs with 52,000 (Pennsylvania) and 43,000 (Maryland) LLCs formed and less than 7,000 (Pennsylvania) and 10,000 (Maryland) corporate charters filed.
     - Kentucky and Nevada are similar with 21,000 (Kentucky) and 19,000 (Nevada) LLC formations in 2016 compared to 2,100 (Kentucky) and 4,500 (Nevada) corporate formations.
   - The reported misuse of alternative entities currently casts a shadow over all U.S. entities, including corporations.
   - These realities compel a conclusion that the same beneficial ownership information and transparency standards be imposed on all entities.  

2. Partnerships and business trusts (whether statutory or common law), which, as a practical matter, are alternative forms of business entities, should be treated similarly to all other business entities.  

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9 Donative trusts, which are traditional estate planning and property owning vehicles, but are not generally regarded as business entities or required to register with any State, also need to be considered.  

10 The scope of entities covered under beneficial ownership reporting legislation could be similar to the scope of entities that are “registered organizations” under the Uniform Commercial Code, where a registered organization means “an organization organized solely under the law of a single State or the United States by the filing of a public organic record with, the issuance of a public organic record by, or the enactment of legislation by the State or the United States.”
Penalties for Noncompliance Should be Calibrated to the Nature of the Noncompliance

1. It is expected that legislation will include criminal penalties for failure to comply with beneficial ownership information disclosure.
   - Recent proposed Federal beneficial ownership disclosure legislation has included both civil and criminal penalties.
     - The Counter Terrorism and Illicit Finance Act imposes criminal penalties for both “knowing” and “willful” violations of its requirements.\(^{12}\)
       - Knowledge generally relates to knowing the relevant facts, even if the actor was not aware that the action was illegal.
       - Willful generally relates to the intent to do something that is illegal.
     - The CLAMP Act imposes criminal penalties on anyone who “willfully” or “intentionally” attempts to evade its requirements.
       - “Intentional” conduct results in greater penalties; treats a pattern of failing to provide or update information as an intentional failure.
       - Criminal penalties include imprisonment for not more than three years.
     - The 2016 U.S. Treasury proposal provided for civil penalties and no criminal penalties.

2. Criminal penalties for “knowing” violations without knowledge that the action is illegal or that the information is false essentially criminalize failures of recordkeeping, particularly activities of closely-held entities conducting legitimate small business activities.
   - Failure to comply should only be a crime if there is “mens rea” – i.e., a willful attempt to evade the requirements or knowing provision of false information.
   - It is inappropriate to impose criminal liability for “knowing” violations where the rules are objectively vague or unclear.

3. Existing international requirements provide for criminal penalties.
   - Failure to comply with the requirements of the UK PSC regime is a criminal offense and the entity and its directors may face fines, imprisonment or both.\(^{13}\)
   - According to the Organisation for Economic Co-operation and Development 2016 report on disclosure of beneficial ownership, failure to comply with statutory beneficial ownership disclosure obligations can constitute a criminal offense in Hong Kong, China, Malaysia, Singapore and Thailand, which can result in large fines and/or imprisonment.\(^{14}\)

4. Most states have adopted various types of fiduciary reporting for corporations (e.g., including names of directors or executive officers in an annual report), but because they do not have the resources to actively enforce compliance, a practical approach to compliance has been adopted.
   - The MBCA allows a corporation 30 days to correct information deficiencies.
   - Although there are no criminal penalties for failure to comply with existing fiduciary reporting requirements, the MBCA allows states to seek administrative dissolution of a corporation for the failure to file an annual report.

\(^{11}\) Subject to review by criminal law constituencies.

\(^{12}\) Under the Counter Terrorism and Illicit Finance Act, it is unlawful for a person (including an applicant to form a corporation or limited liability company) to knowingly provide or attempt to provide false or fraudulent beneficial ownership information, or willfully fail to provide complete or updated beneficial ownership information to FinCEN.

\(^{13}\) The UK PSC regime also permits companies to impose transfer or payment restrictions as a remedy for failure by shareholders to respond to reporting inquiries.

\(^{14}\) For example, in Singapore any person who intentionally or recklessly contravenes the disclosure requirements, or furnishes any information which such person knows is false and misleading, is be liable on conviction to a fine not exceeding $250,000 or (in the case of an individual) to imprisonment of up to two years or both.
1. The existing inconsistent reporting framework in the United States supports the adoption of a Federal approach to disclosure of beneficial ownership information by all U.S. entities, with enforcement including a combination of Federal and state penalties. This is the conclusion that the FATF reached in its December 2016 Fourth Mutual Evaluation Report (the FATF Report) on anti-money laundering and counter-terrorist financing measures in the United States.

- The FATF Report reviewed the framework for the formation of U.S. legal entities and the reporting of information by U.S. legal entities, noting that no adequate mechanisms are in place to ensure that beneficial ownership information is obtained by legal entities and available at a specified location in the U.S. or can otherwise be determined in a timely manner by a competent authority.
- The FATF Report also reviewed the information collected by the IRS, including “responsible party” information, concluding that the definition of a responsible party is not consistent with the FATF definition of beneficial owner and that not all legal entities are required to obtain an EIN.
- In concluding that the United States was non-compliant in its transparency as to the beneficial ownership of legal persons, the FATF Report said that the major gap is “the generally unsatisfactory measures for ensuring that there is adequate, accurate and updated information on beneficial ownership information that can be obtained or accessed by competent authorities in a timely manner.”
- After analyzing the Federal and state reporting framework in the United States, the FATF Report concluded that steps should be taken to “ensure that adequate, accurate and current beneficial ownership information of U.S. legal persons is available to competent authorities in a timely manner, by requiring that such information is obtained at the Federal level.”

2. Federal legislation could be adopted to require that “adequate, accurate and current beneficial ownership information of U.S. legal persons is available to competent authorities in a timely manner” by mandating either a Federal system or a state system.

- Federal identification has the advantage of uniformity (similar to IRS reporting) and efficiency of enforcement by law enforcement authorities, but may lag entity formation and access may be subject to political pressures.
- State identification could match the reporting with entity formation, but many may lack the financial and personnel resources to enforce fiduciary reporting.

3. Either system should provide for the following.

- The identification of a records contact\(^{15}\) in the United States, who must be an individual U.S. citizen who has agreed to provide beneficial ownership information in response to an appropriate request from an authorized recipient, to be designated as such at the time of entity formation and updated at least annually.
  - No other information beyond the name and address of the records contact would be reported to the authorized recipient.
- The records contact would maintain the following information (which in all cases would include the name and address of at least one natural person resident in the United States).\(^{16}\)

\(^{15}\) Although the FATF Report concluded that the definition of “responsible party” in the IRS rules is not consistent with the FATF definition of “beneficial owner” and that not all legal entities are required to obtain an EIN, Federal legislation could amend the relevant IRS rules to implement the “records contact” framework and, as proposed in the CLAMP Act, require that every United States entity obtain and have an EIN.

\(^{16}\) The information maintained by the records contact would supplement the fiduciary information otherwise provided on an annual basis to the appropriate secretary of state.
- The name and address of each “applicable” beneficial owner (i.e., each person with ownership or voting power of 25% or more, and, if no natural person has direct or indirect ownership or voting power of 25% or more, the name and address of the natural person who exercises ultimate effective control over the entity, which would include any natural person fiduciary of the entity).
- For each applicable beneficial owner that is not a natural person, (i) the jurisdiction under which each such beneficial owner was formed and (ii) any natural person who has direct or indirect ownership or voting power of 25% or more of such beneficial owner.
- For each applicable beneficial owner that is not resident in the United States, the name and address of a natural person resident in the United States who has access to the beneficial owner’s records (including for each applicable beneficial owner that is not a natural person, the name of each record owner of such beneficial owner and the jurisdiction under which each non-individual record holder was formed).

- Federal civil penalties on any entity that either fails to maintain records contact information or fails to provide its records contact with the information that the records contact is required to maintain.
- Federal criminal penalties only for willful violations.

4. Given the regulatory regime and transparency rules to which they are already subject, and for the reasons explained above, public entities (i.e., entities with common equity securities registered under the Securities Exchange Act of 1934) and their controlled affiliates should be excluded or exempt from beneficial ownership disclosure requirements.

5. Small business entities engaging in active businesses at a physical location also should be excluded or exempt from beneficial ownership disclosure requirements.

- For example, the Counter Terrorism and Illicit Finance Act includes an exception for an entity with 20 or more full-time employees, over $5 million in “gross receipts” or sales, and an operating presence at a physical office within the United States.

6. Consideration could be given to Federal legislation that mandates state legislation to provide for the following.

- Administrative dissolution of an entity if the entity does not designate a records contact with access to the entity’s beneficial ownership information or does not keep the records contact information up to date at least annually.
- Equity owner disenfranchisement if a beneficial owner fails to report information to the records contact.\(^{17}\)
- Restrictions on the exercise of control by persons who exercise control through a means other than equity ownership (e.g., contractual arrangements, such as voting agreements).

7. The goal of the framework described above is “smart” enforcement where the compelling interests of law enforcement in having prompt access to a natural person who controls an entity are balanced against valid confidentiality interests and the burdens of compliance with reporting requirements, especially if they are not clear and reasonable.

- The identification of a records contact (who is an individual U.S. citizen with access to the required beneficial ownership information) by all entities strikes this balance.
- Broader measures, such as public registries, could infringe on valid confidentiality interests and subject entities and individuals to penalties for not taking actions that would not be relevant to law enforcement.

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\(^{17}\) Equity owner disenfranchisement could resemble the UK PSC regime described above or the treatment afforded to shares that violate ownership limitations in certain regulated entities, such as communications or shipping companies or real estate investment trusts, where disenfranchised shares are transferred to a charitable trust.
o As a matter of enforcement, spreading the focus and increasing the amount of information actually benefits those who commit the illegal acts.

o In addition, broader measures impose costs on capital formation, including by creating significant compliance costs, and reduce the wealth creating potential of forming entities.
Case Law Reviews

As this issue of the LLC & Partnership Reporter goes to press, the final case law summaries to be presented at the Orlando meeting are not yet available. Those documents will be posted to the Committee’s page on the ABA’s website, no later than shortly after the Orlando meeting. Look there for those resources.