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To: Joint Editorial Board for Uniform Unincorporated Organization Acts
From: Harry Haynsworth
Date: November 14, 2002
Re: Rationale for a Uniform Business Trust Act

A. Background

The use of trusts for commercial entities as opposed to trusts created for donative purposes became fairly widespread during the 19th Century. These commercial purpose trusts were originally called Massachusetts trusts (some of the existing state statutes still retain that name in the title) or business trusts. Although not as widely used as other business entity forms (Delaware, which apparently has the largest number had 1,807 registered business trusts in 1996), there are several highly specialized types of businesses where the business trust format is increasingly used as an alternative to a corporation. Approximately one-half of all mutual funds, for example, are organized as business trusts. Pension funds that are subject to ERISA (the Employee Retirement Income Security Fund Act of 1974) are required to be held in a trust vehicle. Business trusts are also widely found in asset securitization financing where various assets such as accounts receivable or real estate mortgages are transferred to a business trust that functions as a bankruptcy remote vehicle to protect the transferred assets from creditors of the transferor or the trustee. Some of these asset securitization trusts have fancy names like REMICs (Real Estate Mortgage Investment Conduits) and FASITs (Financial Asset Investment Securitization Trusts). REITs (Real Estate Investment Trusts) are also frequently formed as business trusts because of the ability to easily achieve flow through tax treatment under Section 856 et seq. of the Internal Revenue Code. Other specialized areas where business trusts are frequently used are Oil and Gas Royalty Trusts, and various types of regulatory compliance trusts such as Nuclear Decommissioning Trusts and Environmental Remediation Trusts for environmental cleanup purposes. A recent law review article pointed out that the business trust format is also suitable for land conservation trusts. See Marianne Guerin - McManus, Conservation Trust Funds, 20 UCLA J. Envir'l L. & Policy 1 (2001-2002). In sum, although there are very few business trusts on a comparative basis with other business forms, trillions of dollars of assets are invested in this business trust format.

There are several reasons why a business trust can be the preferable business format for high volume asset special purpose vehicles. Since they are considered unincorporated associations for federal tax purposes, the entity level tax that is applicable to corporations taxed under Subchapter C of the Internal Revenue Code is avoided (many state business trust statutes, however, specify that a business trust will be taxed for state purposes as a corporation). Second, the business trust format allows more governance flexibility than is possible under most state corporation statutes. The relationship between the trustees and the beneficiaries will be whatever the trust instrument says. This includes

matters such as the fiduciary duties of the trustees, which can be modified by the trust instrument. In this respect, a business trust resembles a partnership formed under the Uniform Partnership Act (1997). Financial flexibility, compared to a corporation, is also an important attribute of business trusts. There are no restrictions on the types, class or number of securities that can be issued to holders of beneficial interests in a business trust, as there are in most corporate statutes which require shareholder approval for many types of new financing. Finally, a business trust, at least in most states, has the same limited liability protection as in a corporation. A business trust also provides limited liability protection for the trustees and in addition, as pointed out above, insulates the trust assets from creditors of the transferor of assets to the trust.

Based on the large amount of money that flows through business trusts in the United States, you would think that the state statutes that apply to business trusts would be fairly extensive and comprehensive along the lines of other modern statutes that govern other business forms. This is simply not the case. Not all states have any business trust legislation (about 34 states have some form of business trust statute) and most of the existing state statutes are very incomplete and inconsistent with one another. A few states (e.g. Mississippi and Nevada) have statutes that authorize foreign business trusts to register to do business but apparently have no statutes governing domestic business trusts. Some of the existing statutes specify that the state's corporate statutes govern the operations of a business trust, whereas others say that business trusts are unincorporated entities and the applicable law is, for the most part, common law trust law. Some say that a business trust can have perpetual existence. Others state that the Rule Against Perpetuities applies. Many states require that the entire trust agreement (and all amendments) be filed in the office of the Secretary of State; while a few require only a short form certificate similar to a limited partnership certificate be filed. The existing statutes also vary widely with respect to the provisions that specify the liability protection that exists in a business trust. Some for example, specify that both the holders of beneficial interest and the trustees have limited liability equivalent to a corporation. Others, however, explicitly provide for limited liability for holders of beneficial interests but are silent on the liability of trustees. Most fail to cover the liability issue in any respect.

The most complete state act is the Delaware Business Trust Act, enacted in 1988 and amended several times, most recently in 2002. It has been the model for at least three other states that have recently adopted business trust states: Nevada, New Hampshire and Virginia. Most of the state statutes, however, appear to have been enacted before the 1970s. Typically they are quite short and contain anywhere from 4 to 10 sections, most of which deal with filing issues. In contrast, the Delaware Business Trust Act has 24 Sections governing domestic business trusts and 12 sections governing foreign business trusts. The following list of section titles provides a summary of the subject matters covered by the Delaware Act.

Domestic Business Trusts

- §3801. Definitions.
- §3802. Contributions by beneficial owners.
- §3803. Liability of beneficial owners and trustees.
- §3804. Legal proceedings.
- §3805. Rights of beneficial owners in trust property..
- §3806. Management of business trust.
- §3807. Trustee in state.
- §3808. Existence of business trust.
- §3809. Applicability of trust law.

- §3810. Certificate of trust; amendment; restatement; cancellation.
- §3811. Execution of certificate.
- §3812. Filing of certificate.
- §3813. Fees.
- §3814. Use of names regulated.
- §3815. Merger and consolidation.
- §3816. Derivative actions.
- §3817. Indemnification.
- §3818. Treasury interests.
- §3819. Access to and confidentiality of information; records.
- §3820. Conversion of other business entities to a business trust.
- §3821. Approval of a conversion of a business trust.
- §3822. Reserved power of state to amend or repeal chapter.
- §3823. Construction and application of chapter and governing instrument.

Foreign Business Trusts

- §3824. Short title.
- §3851. Law governing.
- §3852. Registration required; application.
- §3853. Issuance of registration.
- §3854. Name; registered office; registered agent.
- §3855. Amendments to application.
- §3856. Cancellation of registration.
- §3857. Doing business without registration.
- §3858. Foreign business trusts doing business without having qualified; injunctions.
- §3859. Execution; liability.
- §3860. Service of process on registered foreign business trusts.
- §3861. Service of process on unregistered foreign business trusts.
- §3862. Fees.

The Delaware Business Trust Act is not only comprehensive but it is one of the few state acts that authorizes both for-profit and not-for-profit business trusts and also authorize mergers and conversions of business trusts with other business entities. Business trusts formed under the Delaware Business Trust Act are apparently well accepted in the securities market place since most of the existing large sophisticated financial business trusts have been formed as Delaware business trusts. The one exception may be REITs, which are more ubiquitous than other forms of business trusts. The Delaware Business Trust Act would, therefore, be a good model for a Uniform Business Trust Act, if a decision is made to undertake a business trust drafting project.

B. Rationale for a Uniform Act

Business trusts are clearly special purpose vehicles as opposed to the more common forms of business entities such as corporations, partnerships and limited liability companies. The closest equivalent is a limited partnership, which is currently used for certain types of real estate ventures and also for family business financial planning. In most cases, businesses formed as limited partnerships could achieve the same tax liability and other benefits if they had been organized as limited liability partnerships or limited liability companies. Nevertheless, NCCUSL in 2001 approved

a revised Uniform Limited Partnership Act. In addition, NCCUSL currently has a Study Committee investigating the possibility of a Uniform Cooperative Act. Cooperatives are, like business trusts, special purpose vehicles currently used primarily for farm products. Business trusts are also like cooperatives in two other respects: (1) There are relatively few in number and (2) those that do exist are, for the most part, quite large in terms of the dollar volume of investments and operations.

Moreover, business trusts are unincorporated business associations and this is a subject area where NCCUSL has traditionally drafted uniform acts. Furthermore, most of the issues that need to be dealt with in a business trust statute, including the default rules, fiduciary duties and the ability to limit these duties, and limited liability are the same as those encountered in RUPA (1997) RULPA (2001) and ULLCA (1997).

Furthermore, the incompleteness of the business trusts statutes in most states and the absence of any applicable legislation is about one-third of the states creates significant legal uncertainty in the operation of business trusts on an interstate basis. A uniform act that is widely adopted would eliminate this uncertainty. At the very least, a Uniform Business Trust Act would be appropriate for those states who wish to enact a well-drafted, comprehensive business trust act.

Finally business trusts, particularly those formed under the Delaware Business Trust Act, are well accepted in the securities market. There is no indication that they will disappear anytime soon, despite the availability of other tax pass-through business entities such as partnerships and limited liability companies. If anything, the number of REITs and asset securitization trusts formed as business trusts is increasing. A strong argument can be made for the proposition that a Uniform Business Trust Act, assuming it is widely adopted, will further the acceptance and use of business trusts.

The principal arguments against a Uniform Business Trust Act are: (1) there are comparatively very few business trusts in existence; (2) most of the largest business trusts in terms of investment dollars and numbers of equity owners have been formed as Delaware business trusts; (3) because of the small number of business trusts, it might be difficult to get momentum for widespread adoption of a uniform act; (4) there are already too many types of business forms.

The numbers issued has been discussed above. The Delaware monopoly is somewhat specious, in my opinion. If the Delaware Business Trust Act is superior to most other existing state acts, then it should be adopted as the model for a uniform act. Many Delaware lawyers I have discussed this issue with, however, are not very keen on the idea of other states adopting a modern, comprehensive business trust statute. I wonder why?

The widespread adoption issue is a serious concern. Since approximately 34 states currently have business trust statutes, most of which are antiquated an incomplete, there should be positive receptivity for a Uniform Business Trust Act in these states (with the possible exception of Delaware and the other states that have legislation patterned on the Delaware Business Trust Act). Widespread adoption in these states may create the necessary momentum for the remaining states who currently have no business trust statute to adopt a uniform act.

Finally, the argument that there are already too many types of business entities is not persuasive in the absence of a uniform business entity act that collapses all of the existing types of unincorporated associations into a single business format, something that is very unlikely to occur anytime soon. There is clearly a market for the many different types of business entities that exist today, including business trusts. As long as this is the case, uniform acts for each type are desirable and should be made available for adoption by all states.

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December 3, 2002

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Re: JEB Meeting Summary – November 23, 2002

Dear Committee Members:

Without intending to preempt the work of our distinguished secretary, Michael Bamberger, I have prepared the enclosed one page summary of my understanding of the decisions reached on the items described at our meeting on November 23. I knew that if I did not set forth my understanding on what we did on each of the items, my recollection would shortly begin to fade. I would appreciate each of you reviewing the summary at your earliest convenience and advising Michael and me of any corrections or additions for his assistance in preparing the minutes.

Best wishes for the holidays.

Sincerely yours,

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AGD/ch

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MEETING SUMMARY

Joint Editorial Board on the Uniform Unincorporated Organization Acts November 23, 2002 Washington, DC

1. Ann Anker proposed, and was asked to prepare recommendation on, an amendment to RUPA for LLPs imposing limitations on distributions and obligations to return of the type typically found in other limited liability entity statutes. Delaware RUPA has such a provision.
2. Harry Haynsworth raised the question of whether it was time to ask the ABA to revisit its earlier decision not to approve the Uniform Non-Profit Unincorporated Organization Act. It was the consensus that in view of other pending matters, the subject should be deferred.
3. The Board concurred in a proposal by Harry Haynsworth to recommend to the Scope and Program Committee of NCCUSL that it open a project to consider undertaking updating the Uniform Limited Liability Company Act. The Board's recommendation left open the question of whether the approach should be the appointment of a study committee or a drafting committee.

Bob Keatinge stated his view that the ABA Partnership Committee would not resist the undertaking by NCCUSL nor view it as competition with the Partnership Committee's plan to update the Prototype LLC act.

4. King Burnett reported on his meeting that morning with the leadership of the ABA Business Law Section on the uniform and model cross-entity merger statutes. The consensus view of the JEB was that the leadership's proposal was very constructive and could provide a basis to resolve the issues to go forward.
5. King also reported on his discussion that morning with the ABA Business Law Section leadership on the NCCUSL project to study a universal business organization statute. He said that he had made clear that NCCUSL was not trying to preempt the ABA nor would it undertake a drafting project without the section leadership wanting it done.
6. Bill Henning and Harry Haynsworth reported that a NCCUSL study project was underway on a Uniform Cooperative Act, the present scope of which was limited to farm and related activities. The Board recommended that the scope of the project be broadened.
7. The Board recommended that NCCUSL appoint a drafting committee to prepare a Uniform Business Trust Act.

AGD/ch