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Another Sarbanes–Oxley: Threatening Small Businesses with the "Beneficial" Ownership Bill

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Abstract: *At a time when the American economy can least afford it, entrepreneurs and small-business owners are under siege. The Incorporation Transparency and Law Enforcement Assistance Act (ITLEAA)—currently under consideration in Congress—would subject small businesses to a series of complicated and burdensome reporting requirements. These new requirements are reminiscent to those imposed by Sarbanes–Oxley, and would have similarly negative consequences: increased costs and reductions in business activity and job creation. Furthermore, the ITLEAA would do little to actually reduce the use of LLC forms for criminal activity—the purported goal of the legislation.*

American entrepreneurs form approximately two million limited liability companies (LLCs) and corporations each year. The vast majority of these LLCs are small businesses, often family-run companies that will never issue regulated securities or be traded on any market. For that reason, they are exempt from the complicated and burdensome reporting requirements of laws, such as the Sarbanes–Oxley Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes–Oxley), that are intended to protect unsophisticated investors buying shares in the public market. While such laws put larger American businesses at a competitive disadvantage against foreign rivals, they would simply wipe out smaller businesses that could not afford the cost of compliance.[1]

Talking Points

- The Sarbanes–Oxley Act of 2002 imposed complicated and onerous regulatory burdens on public companies—burdens that have harmed the U.S. economy and put American businesses at a competitive disadvantage against foreign rivals.
- The proposed Incorporation Transparency and Law Enforcement Assistance Act would subject private and closely held businesses to similarly burdensome reporting requirements, increasing the costs and liability risks of business formation and maintenance.
- ITLEAA relies on vague definitions that would provide little guidance to business owners, requiring them to hire lawyers and accountants or accept the risk of noncompliance, including civil and criminal penalties, as well as imprisonment.
- ITLEAA would require detailed disclosure of confidential information on privately owned businesses, thereby infringing upon the privacy interests of owners.
- At a time when America's economy can least afford it, ITLEAA would reduce the number of new business formations, and provide little deterrent to criminals who could simply and easily falsify the information they are required to report.

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The Incorporation Transparency and Law Enforcement Assistance Act (ITLEAA), sponsored by Senator Carl Levin (D–MI), would subject smaller and closely held businesses that are exempt from securities regulation to similarly burdensome requirements.[2] To combat the rare use of the corporate and LLC form for criminal purposes, ITLEAA would require *all* new businesses taking these forms to report a variety of information concerning "beneficial ownership" at the time of their formations and forever after or face the risk of civil and criminal fines, as well as imprisonment, for errors or omissions. Further, the legislation relies on vague definitions that would provide little guidance to business owners, requiring them to hire lawyers and accountants or accept the risk of noncompliance.

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By increasing the cost of business formation and maintenance, ITLEAA would reduce the number of businesses formed and cause many precarious new businesses—and in their early years, most businesses are financially precarious—to fail.

At the same time, it would provide little deterrent to criminals, who could choose other business forms that are less advantageous to those conducting legitimate businesses—such as partnerships—or simply falsify the information they are required to report. After all, individuals willing to commit major felonies like drug trafficking or money laundering will not hesitate to misreport required corporate information. At a time when the U.S. economy is even more dependent on the development of small and closely held businesses for job creation, growth, and ensuring America's economic recovery, Congress should not erect new barriers to the success of small enterprises.

Background

Business creation is primarily a matter of state law. Though there are uniform acts for business entities that many states have adopted in whole or in part, every state has its own unique law and culture of business formation, specifying the rights and responsibilities of those who partner, incorporate, or form limited liability companies. Not only has this body of law evolved over centuries to meet the needs of entrepreneurs and the public, but it has also seen brisk growth in recent years with the rise of LLCs, limited liability partnerships (LLPs), and other novel creations. The law of business entities is truly an area where the states function as "laboratories of democracy," taking different approaches, learning from one another's successes and failures, and most importantly, competing to attract entrepreneurs and spur economic growth and development.

Such innovation has increased entrepreneurial efficiency by improving business governance, reducing the cost and difficulty of business formation, and democratizing access to limited liability forms, thereby reducing the risks faced by individual entrepreneurs and investors. Some scholars have gone so far as to predict that recent innovations in business entity law—once seen as a dry, static area of the law—point the way to new models of business organization that could eventually render the corporate form, and all of the headaches of public ownership, obsolete.[3] LLCs, for example,

1. According to Alex J. Pollock of the American Enterprise Institute, there is no doubt that the onerous regulatory burden imposed by Sarbanes–Oxley "has played an important role in moving capital market activity, and initial public offerings in particular, out of the United States and into London and other foreign markets." The Honorable Tom Feeney, David C. John and Alex J. Pollock, *Reforming Sarbanes–Oxley: How to Restore American Leadership in World Capital Markets*, Heritage Foundation Lecture No. 995, February 21, 2007, *available* at http://www.heritage.org/Research/Regulation/upload/hl_995.pdf.
2. Incorporation Transparency and Law Enforcement Assistance Act, S. 569, 111th Cong. (2009).
3. Larry Ribstein, *SOX for the Little Guy*, July 12, 2009, http://busmovie.typepad.com/ideoblog/2009/07/sox-for-the-little-guy.html.

have already become the preferred form for many types of innovative financial vehicles, such as hedge funds. When entrepreneurs have access to these more efficient entities, they are able to devote more resources to doing business, and less to maintaining formalities. This innovation has helped the United States to maintain favorable economic conditions, even at a time when growth-stifling regulation has, in general, been on the rise.[4]

Foreign competitors, however, are working to eliminate that advantage by pressuring the United States to "harmonize" its laws with their own. In 2006, the Financial Action Task Force, an intergovernmental organization established by the G-7 Summit in 1989 that sets voluntary standards on laws to combat money laundering and terrorist financing, issued a report criticizing the United States for its failure to comply with an FATF recommendation on the disclosure of the ownership of business entities.[5]

ITLEAA: Burdensome and Unnecessary

Senator Levin first introduced ITLEAA in 2006, and the same bill was reintroduced in May 2009. The legislation uses existing homeland security grants as a lever to force states to amend their corporation law to comply with new federal requirements. In particular, these amended laws would require those forming new corporations and LLCs to provide to the state where the formation is occurring a list of the "beneficial owners" of the business. "Beneficial owners" are defined as any individual "who has a level of control over, or entitlement to, the funds or assets of a corporation or limited liability company that, as a practical matter, enables the individual, directly or indirectly, to control, manage, or direct the corporation or limited liability company."[6]

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The information required on the beneficial owners would include their names, addresses, and means of control over the business, such as through a partnership or trust. This information would have to be updated annually in states that require annual filings, or at the time of changes in beneficial ownership in states that do not, and would have to be maintained for five years after the entity terminates.[7]

The legislation demands even more information of foreign owners of U.S. businesses. Individuals forming businesses would be required to certify that they have verified the name, address, and identity of each owner who is not a citizen or permanent resident and that they have obtained a copy of the photograph page of each foreign owner's passport.

This information would have to be disclosed "upon receipt of a written request" from a federal agency on behalf of another country under an international treaty, agreement, or convention, or under 28 U.S.C. 1782 (assistance to foreign and international tribunals). It would also have to be disclosed in response to a subpoena or summons from a state or federal agency or a congressional committee.[8]

Finally, the law would impose additional requirements on individuals forming new corporations and LLCs. It amends the United States Code to include these "formation agents" in the definition of "financial institutions"—along with banks, credit unions, and the like—thereby subjecting

4. *See* Clyde Wayne Crews, Ten Thousand Commandments: An Annual Snapshot of the Federal Regulatory State (Competitive Enterprise Institute) (2008), *available at* http://cei.org/node/20855; The World Bank Group, Doing Business 2010: Reforming through Difficult Times, World Bank Group (2009).

5. Incorporation Transparency and Law Enforcement Assistance Act, S. 569, 111th Cong. § 2(6) (2009); *see also* The Financial Action Task Force, *http://www.fatf-gafi.org/pages/0,2987,en_32250379_32235720_1_1_1_1_1,00.html.*

6. Incorporation Transparency and Law Enforcement Assistance Act, S. 569, 111th Cong. § 3 (2009).

7. *Id.*

8. *Id.*

them to a variety of recordkeeping and reporting regulations under existing federal law.[9]

Violations of any of these requirements would carry harsh penalties. ITLEAA provides no additional funding for states to come into compliance and most existing DHS funding is already earmarked for specific purposes at the county and local levels. Individuals, meanwhile, would face civil and criminal penalties for failure to comply. Specifically, providing incorrect beneficial ownership information or intentionally failing to provide updated ownership information would be punishable by civil fines up to $10,000, criminal fines, and imprisonment up to 3 years.[10] Despite the fact that ITLEAA's requirements would be implemented through state law, civil and criminal fines would be paid to the federal government for violations—a reflection of the legislation's dismissive attitude toward federalism and state sovereignty.

Violations of ITLEAA are punishable by civil fines up to $10,000, criminal fines, and imprisonment up to three years.

Formation agents would additionally face civil and criminal liability for violations of Treasury recordkeeping and reporting regulations applicable to financial institutions. Even accidental errors and omissions could, in some circumstances, be subject to large civil penalties.[11] Willful violations would be punishable by fines up to $250,000 and imprisonment up to five years.[12]

Unanswered Questions

ITLEAA promises to impose massive burdens upon the states. To begin with, it would upset and preempt states' existing registration systems. Registration processes that have evolved over decades to meet the needs of businesses and the public would not be in compliance with ITLEAA's alternatively vague and detailed requirements. Replacing these systems with ones that comply with ITLEAA's complicated filing and retention requirements promises to be both disruptive and expensive. The expense would be particularly high in states that do not impose annual filing requirements—those states are required by the bill to update records on a real-time basis.

Compounding these difficulties is the challenge of administering ITLEAA due to its fundamentally vague definition of "beneficial owner." ITLEAA's definition raises more questions than it answers. Because it does not contain a clear-cut definition of ownership—for example, possession of more than 10 percent of the stock of a corporation—it requires a looser, more subjective analysis to determine legal requirements. For example, the definition requires reporting on anyone who "directly or indirectly" controls, manages, or directs the corporation—even family members who exercise informal control over a closely held corporation could be considered "beneficial owners." Thus, the owner and president of a closely held corporation could be compelled to report the extent of informal control that his wife and mother-in-law exercise over his decisions.

ITLEAA's definition of "beneficial owner" would also require "piercing" the ownership structures of non-individual entities. For example, a corporation that is partly owned by a trust would be required to report changes in the ownership of the trust, both in terms of rights to distribution and rights to control. And if an entity that owns part of a corporation or LLC is, in turn, owned by another entity (hardly an unusual occurrence), the corporation or LLC would be required to trace the rights to distribution and control all the way up the chain until they reach individuals—an extremely arduous, and potentially impossible, task.

Moreover, the corporation or LLC would be required to monitor the ownership and (direct or indirect) control structures of all the entities in that

9. *See* 31 U.S.C. § 5311 et seq.

10. Incorporation Transparency and Law Enforcement Assistance Act, S. 569, 111th Cong. § 3 (2009).

11. 31 U.S.C. § 5321.

12. 31 U.S.C. § 5322.

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chain for changes, which it would be required to report annually or, somehow, as they occur. It is, at the very least, unclear as to how corporations and LLCs are supposed to know about ownership changes in legally distinct entities, especially when the changes they are required to report do not coincide with and are far broader than, notions of legal ownership in other areas of the law. So an LLC owned, in part, by a partnership might be required to report that the partnership has lately been subject to greater control, "as a practical matter," because one of the partners got married and the new husband has taken an active, even if technically informal, role in the partnership. The partnership, on the other hand, would not be required to report anything at all.

ITLEAA promises to impose massive burdens upon the states.

ITLEAA's "beneficial owner" definition leaves many basic questions about determining ownership unaddressed, including:

- Does any percentage of ownership, no matter how small, render an individual a beneficial owner?
- Does contingent ownership, such as stock options, confer ownership? Does it matter whether the options are "above water"?
- Does non-voting stock confer beneficial ownership?
- Are creditors beneficial owners? Does it matter whether a creditor is able to exercise control over aspects of a business's operations? What about whether a creditor is able to exercise a degree of control over a corporation or LLC's actual owners?
- Are all board members of a closely held corporation, regardless of their ownership interests, beneficial owners due to the control that they potentially exercise over the corporation? Does it matter whether the board's powers are restricted in the corporation's charter or otherwise?
- Do the rules adopted by a corporation for the election of its board figure into determining beneficial ownership? For example, if unanimity is required to elect a board member, does that render any shareholder, and all those who may in some way "control" him, a beneficial owner?
- Are all family members of individuals who are beneficial owners themselves also beneficial owners—or at least those who may be said to practically exercise some control over the business entity, even in the absence of any formal holdings in the business?
- Are managers considered beneficial owners, even if they possess no equity stake in the business? If so, which managers? Does it matter that the Vice President for Operations may have more responsibility for managing the business as a whole than the Vice President for Personnel?
- For a business owned in part by a trust, does it matter whether the trust is revocable or irrevocable?
- Is a trustee who is not a beneficiary of a trust that owns, in part, a corporation, a beneficial owner?

Under ITLEAA, states would face an unattractive choice: live up to the letter of this invasive federal law and require small businesses to file excessive and meaningless reports, or cut corners and risk falling out of compliance.

Big Burdens on Small Businesses

ITLEAA will have a significant and negative effect on small-business formation and survival. Businesses that today are exempt from onerous reporting requirements would see their paperwork burden multiply. Entrepreneurs would spend more time complying with red tape, and have less time to ensure the success of their businesses.

Under current law, two entrepreneurs starting a small business can fill out all of the required paperwork to form an LLC in a matter of minutes. Pennsylvania, whose requirements are typical of most states, requests only the following information: the name of the business (which must reflect its status as an LLC), an address for official correspondence, the names and addresses of its organizers, and the date the certificate is to go into effect.[13] The filing fee is $125. The state requires an annual filing—a one-page form requesting the business's current address—to maintain the LLC.[14]

The simplicity of current law gives entrepreneurs the power to form businesses quickly and with little expense or confusion. Do-it-yourself kits, containing the forms, standard legal advice, and draft contracts are available online for less than $100, and many attorneys offer formation guidance for a flat fee, usually around $500 for simple cases.

Under ITLEAA, however, forming a small business would be far more complicated. For example, an entrepreneur seeking to form an LLC would be required to ascertain the beneficial owners of the business, a potentially difficult task for even a small business that is being funded by family members or with an investment from a family trust. Businesses relying on foreign funding, such as from family members living abroad, would have to collect even more information. Registration forms that previously took minutes would take hours, days, or weeks. Many individuals would also require legal advice to ensure that they are fulfilling all of the law's specific requirements.

The complexity of the regulatory scheme would render it highly risky and irresponsible, if not impossible, for entrepreneurs to register limited liability businesses without consulting an attorney, an accountant, or both. But at the same time, professionals assisting in business formation, particularly those who qualify as "formation agents" under ITLEAA, would demand greater fees than they do today for their services. Registering a business under ITLEAA would simply require more work and place formation agents at greater risk of legal sanctions.

In addition to expenses, ITLEAA would also present enormous risks to those forming businesses. The managers of businesses that knowingly fail to comply with the law—for example, giving up on tracing ownership past a certain point—would face the risk of civil and criminal penalties, as described above, including imprisonment. The businesses themselves could also face dissolution if states implement ITLEAA's requirements as addendums to their existing entity formation laws. In such instances, entrepreneurs could find themselves without the protection of limited liability and personally responsible for business debts that they never expected to fall upon them directly. Thus, the ITLEAA would put individuals going into business at the risk of personal financial ruin.

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The higher costs and higher risks imposed by a greater (and more confusing) regulatory burden will result in less business activity and less job creation. At a time when unemployment is reaching a 26-year high, the last thing the federal government should be doing is implementing new legal requirements that will make it even harder for entrepreneurs to start new businesses.

Big Loopholes and Even Bigger Burdens

While ITLEAA would impose enormous costs and risk on small businesses, it would do little to prevent determined criminals from forming business entities. A criminal intending to launder money or finance terrorism could form and conduct criminal activities under a sole proprietorship, general partnership, limited liability partnership, or some other business association that is not covered by ITLEAA. A criminal operating under one of these alternative forms would, necessarily, forgo some of the benefits of the corporate and LLC forms, including perhaps limited liability, but a criminal is going to be less concerned about these benefits than individuals operating legitimate businesses who actually have a need for limited liability

13. Corporation Bureau, Department of State, Commonwealth of Pennsylvania, Certificate of Organization of Domestic Limited Liability Company (200), *available at* http://www.dos.state.pa.us/corps/lib/corps/20/7/8913.pdf. Pennsylvania also requires a one-page "docketing statement," which asks for the same information. Commonwealth of Pennsylvania, Departments of State and Revenue, Docketing Statement (2002), *available at*, http://www.dos.state.pa.us/corps/lib/corps/20/7/134A.pdf.

14. Corporation Bureau, Department of State, Commonwealth of Pennsylvania, Certificate of Annual Registration (2002), *available at* http://www.dos.state.pa.us/corps/lib/corps/20/7/8221-8998.pdf.

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and flexibility in governance. Thus, ITLEAA will disproportionately burden legitimate entrepreneurs over those intending criminal ends.

Perhaps for this reason, ITLEAA would commission the Government Accountability Office to study the possibility of expanding its grasp to encompass partnerships, trusts, and other business entities. This step, if it were ever taken, would radically change the law of all 50 states. The United States has a long history of easy formation of simple businesses; indeed, two individuals can form a partnership merely by going into business with each other, without any forms or filing requirements. State law, developed through experience, supplies the default terms of these agreements, reducing the legal expense of starting a simple business to effectively zero.

Carried out to its logical end, ITLEAA would upend the policy of easy business formation that has made America the world's most entrepreneurial society. Individuals intending to start small businesses on shoestring budgets could no longer simply open for business; instead, their first step would be to put their paperwork in order to meet federal and state regulatory requirements. Many would be forced to hire attorneys, and those that do not would face legal consequences (including prison) down the road in the case of errors or omissions. These added costs would make some business activities—such as a temporary partnership to sell products at a single event—impractical and others impossible to get off the ground. Worse, such requirements would have the greatest impact on low-income individuals seeking to start their own businesses.

In addition to increased costs, ITLEAA would also present enormous risks to those forming businesses.

Privacy Concerns for All Privately Held Corporations

ITLEAA also raises significant privacy concerns because it requires detailed disclosure of information on privately owned businesses—businesses that are not listed on stock exchanges and whose shares are generally not open to purchase by the general public. Thus, the reasons justifying disclosure of private information about corporations that are publicly traded—namely, to ensure that potential buyers and investors are fully informed before they purchase shares—simply do not apply to private entities. And as previously stated, ITLEAA is unlikely to achieve its putative purpose of significantly impacting criminal or terrorist activity undertaken through the corporate form—the only conceivable rationale for ITLEAA's onerous disclosure requirements of otherwise private information.

The breach of privacy is likely to have similar negative effects as those previously listed. Those concerned about privacy may forgo certain business opportunities, thereby taking their funds—and possible jobs—out of the stream of commerce. Others concerned with privacy may shift to sole proprietorships or partnerships in order to avoid being swept into the disclosure rules, while still others may conduct their business in foreign jurisdictions with less onerous rules.

Conclusion

Since the passage of the Sarbanes–Oxley Act, "small and mid-sized public companies have struggled to comply with its onerous provisions, which created an enormous and disproportionate regulatory burden."[15] In fact, a growing body of evidence shows that the law is "harming the U.S. economy and its financial industry."[16] Even the GAO reported in 2006 that the cost of compliance with the law had been "disproportionately higher" for smaller public companies."[17]

ITLEAA would do to private, nonpublic companies the same thing that Sarbanes–Oxley has done

15. David C. John and Nancy M. Marano, *The Sarbanes–Oxley Act: Do We Need a Regulatory or Legislative Fix?* Heritage Foundation Backgrounder No. 2035, May 16, 2007, *available at* http://www.heritage.org/Research/Regulation/bg2035.cfm.

16. *Id.*

to publicly traded companies—impose significant new regulatory costs and liability risks. And the literally millions of privately held companies have even less financial ability to absorb such costs than the (generally) larger public companies.

Finally, under the U.S. system of criminal justice, government investigators have the ability to investigate companies and other businesses that are suspected of engaging in money laundering, drug trafficking, terrorism, and the other criminal acts listed in the "Findings" clause of ITLEAA as a basis for this legislation. However, America's constitutional system requires investigators to meet certain legal standards to convince courts or grand juries to issue subpoenas or summonses intended to obtain information needed for a criminal investigation—such as details about who are the "beneficial owners" of a suspected business. There is no valid reason to circumvent these well-functioning rules, and there is no reason that the vast majority of legitimate, privately held businesses should have such a regulatory burden imposed on them because of concerns over the comparatively small number of criminals who use businesses to facilitate criminal acts, particularly when there is no legitimate claim that the law will prevent criminals from engaging in such acts.

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17. U.S. Government Accountability Office, Sarbanes–Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies 4–5 (2006), *available at* http://www.gao.gov/new.items/d06361.pdf.

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