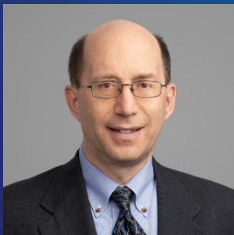
Katten

Family Business General Counsel Seminar

Thursday, June 22, 2023

PROGRAM 1: KATTEN LED

Governance Considerations for Family-Owned Businesses



Jeffrey Patt
Partner, Mergers and Acquisitions
Katten

Thomas Lamprecht
Partner, Mergers and Acquisitions
Katten

Pain Points in Implementing Family Business Governing Documents

Uniqueness of Family Business Governance

- Governance of a family business often can be more complicated than for non-family-owned companies.
- Along with the challenges faced by any other business, there needs to be a balance between family demands and the needs of the business.
- Families working together intensifies family interactions and exacerbates family problems.
  - Ex. Sibling rivalry or generational competition
  - These conflicts can undermine the operation of the business
  - How to "keep the peace"?
- In a family business, good corporate governance measures often can help achieve an appropriate balance and provide more clarity of expectations.

Good Governance

- What are some common elements of good governance:
  - Values to operate within
  - Transparency
  - Information flow
  - Formation of decision making bodies empowered to take action with the values as guiding principles
  - Clear processes to resolve disputes
- Good governance will likely involve different measures at different stages of the life cycle of a family business as the business evolves

Impact of Growth on the Family Business

- As a family business grows and matures, planning is crucial to:
  - accommodating changing family relationships
  - keeping the family unified
  - providing exit mechanisms for those who want to depart
- Evolution of a family business can often be as follows:

Generation	Characteristics
First	• Dominant Founder • Informal Governance
Second	• Board Function emerges • Policies start to get formalized
Third, Fourth, etc.	• Sophisticated Shareholder Agreement • Full governance policies are needed for survival

Common Pain Points

Feature	Pain Point	Suggested Solution
Dominant patriarch/matriarch	Succession planning (most obvious and problematic and least planned for)	Staged departure Empowerment of Board
Even ownership	Vote ties and stalemates	Mediation Buy-sell provision
Non-family owners	Dilution of family	Repurchase rights
Liquidity	Divergent interests on reinvestment v. distribution	Creation of a liquidity fund
Disputes	Keeping the peace	Family advisory board
Aircraft	Allocation of use	Implement formal policy

Use of Professional Advisors

- Families have a tendency to rely on existing family members who they consider to have “experience” (which is sometimes valued over expertise)
- Even the most experienced family members cannot anticipate future issues
- External advisors can help initiate uncomfortable conversations and plan for contingencies that family members may not see (or want to see)
- Sophisticated family businesses rely heavily on outside counsel, accounting firms and tax and other advisors.

Director and Manager Fiduciary Duties

Role of the Board of Directors and Managers

- A corporation is required to have a board of directors.
- In "close corporations," the shareholders may reserve for themselves responsibilities of the board, but in doing so, might assume the liabilities of a board.
- The board has exclusive authority to manage the corporation's business and affairs.
- In exercising this authority, board members are expected to act as "fiduciaries" of the corporation's shareholders.
- For IL corporations, the board, as fiduciaries, also may consider the impact on employees, suppliers, customers, the local community and other "pertinent factors."

LLCs can be more flexible – which might include being "member managed" and/or contractually limiting or eliminating fiduciary duties.

Role of the Board of Directors

- A board may delegate responsibilities to committees and/or officers.
- In IL corporations, the board may <u>not</u> delegate to a committee the power to:
  - — Authorize distributions (expect for dividends on preferred or special classes or series),
  - — Approve or recommend to shareholders any act reserved for shareholder action (e.g., amending Articles, approving a sale of the corporation),
  - — Fill vacancies on the board or any committee,
  - — Elect or remove officers or set committee member compensation,
  - — Adopt, amend or repeal the by-laws,
  - — Approve a plan of merger not requiring shareholder approval,
  - — Authorize or approve repurchasing shares, other than according to a formula/method approved by the board, or
  - — Authorize or approve the issuance or sale of shares (subject to limited exceptions).

Board Fiduciary Duties – Duty of Care

- A board is expected to act on an informed basis after due consideration and appropriate deliberation.
- Board decisions should be based on the material information reasonably available to the board.
- Board reliance – the board may rely, so long as doing so is reasonable and in good faith, on:
  - — Records of the corporation; and
  - — Other information presented by any person if the board reasonably believes:
    - Topics are within the competence of such person, and
    - Such person was selected with reasonable care.
- To prove breach of the board's duty of care, a plaintiff must generally show that the board acted with "gross negligence."

Board of Directors – Duty of Loyalty

- Directors are required to put the interests of shareholders above any of their own personal interests that relate to a proposed action.
- A director is expected to disclose to other directors the existence and nature of any conflict of interest and any other material facts known to such director that would reasonably be anticipated to be material in a decision regarding a proposed action.
- If an action is fair to the corporation when the board authorized it, the fact that a director is a party to the matter is not, by itself, a basis for invalidating the board action or the conflicted director's vote on it.
- But, if a shareholder contests the action on the basis of a conflict, the conflicted director, and/or the board, likely will have the burden of proving fairness, <u>unless:</u> the action was approved by a majority of disinterested directors (even if less than a quorum), <u>or</u> a majority of shareholders, other than the interested director.
- A "disinterested" director is one who will not receive a personal financial benefit from the transaction, other than a benefit shared equally among the shareholders.

Board of Directors – Business Judgment Rule

- **Business Judgment Rule** – a presumption that directors acted on an informed basis, in good faith, and with the honest belief that the action is in the best interests of the company.
- Courts will defer to directors unless a plaintiff overcomes this presumption by alleging facts that would suggest the directors breached their duty of care or loyalty.
  - If a plaintiff overcomes the presumption, the board may have to show the "entire fairness" of its actions – both as to process and outcome.
- Under the business judgment rule, courts generally review the process, not the ultimate outcome.

A Case for Independent Directors

- Advocates of good corporate governance often highlight the benefits that independent directors can offer a board.
- Public discussion on this topic often focuses on public companies, largely because of access to information, prevalence of activists shareholders and shareholder suits, and regulatory and exchange requirements for board independence.
- Nonetheless the core principles debated – lending credibility to conflict situations, diversity of perspectives, and experience – often apply to circumstances that family-owned businesses face.
- These principles may also be relevant where constituencies other than shareholders have a stake in the integrity of the corporation's business decisions.
  - — e.g., regulators, lenders, unions, vendors and customers.
- Sometimes, an advisory board can offer independent perspectives to a board of directors.

Protecting Directors from Liability

- Illinois corporations may include provisions in their Articles of Incorporation that exculpate directors for monetary damages for breach of fiduciary duty, except for violations of duty of loyalty, acts or omissions that are not in good faith or involved intentional misconduct or knowing violations of law, and unlawful dividends, repurchases and redemptions, and transactions from which directors derive an improper personal benefit.
- An Illinois corporation also may indemnify its directors and officers for certain losses and expenses arising out of their service to the corporation (or its subsidiaries), which may include advancing expenses incurred in defending claims.
- An Illinois corporation also may obtain directors and officers insurance.

Using Limited Liability Companies and Partnerships

- Illinois alternative entities statutes (LLCs, limited partnerships) specifically allow for a greater of freedom of contract than the corporate statutes.
- Waivers/limitations on fiduciary duties:
  - — Default fiduciary duties exist, but
  - — Illinois allows members/partners to waive fiduciary duties of members/partners and/or managers to the LLC/LP or other members/partners.
    - Waiver can be general or specific, but should be clearly articulated.

Merger and Acquisition Considerations for Directors and Managers

Delaware Statutory Framework

- DGCL § 141(a) provides that the business and affairs of a corporation are to be managed by or under the direction of a board of directors.
- DGCL § 141(e) further addresses the right of the board to rely in good faith upon:
  - The Company's records,
  - Information and reports presented by Company officers or employees,
  - Information provided by or on behalf of board committees, and
  - Information provided by any other person that the board reasonably believes are within such person's professional competence and who has been selected with reasonable care.
- DGCL § 251(b) requires the board of a company to adopt a resolution approving an agreement of merger and declaring its advisability before presenting it to the stockholders.

Delaware Statutory Framework

- DGCL § 102(b)(7) eliminates or limits the personal liability of a director or officer for monetary damages for breach of fiduciary duty other than:
  - — For breaches of duty of loyalty,
  - — Acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law,
  - — A *director* under DGCL § 174,
  - — Any transaction where the director or officer derived an improper personal benefit, or
  - — An *officer* in any action by or in the right of the corporation.

Delaware Statutory Framework

- In 2022, DGCL § 102(b)(7) was amended to authorize corporations to eliminate or limit liability of *officers* in addition to *directors*.
  - — The amendment was adopted to align outcomes for breach of duty of disclosure when directors and officers are sued.
    - In recent years, claims for breach of the duty of disclosure against directors were being dismissed, while the same claims against officers were allowed to proceed.
  - — The amendment does not prevent the board from pursuing claims against officers in the name of the corporation, nor does it prevent stockholders from bringing derivative claims in which officers are alleged to have breached their duty of care.

Illinois Statutory Framework

- IBCA § 8.05(a) provides that the corporation shall be managed by the board of directors, similarly to DGCL § 141(a).
  - — However, the IBCA provides an exception to § 8.05(a) for close corporations, whereby shareholders may act as management in lieu of a board of directors. *See* IBCA § 2A.45.
- Unlike DE, where DGCL § 141(e) addresses the board's right to rely on books, records, and subordinates, IL has no provision addressing information on which a director may rely.
- IBCA § 11.05 provides that the board must approve a merger by majority vote, setting forth terms, before presenting it to stockholders
  - — Equivalent to DGCL § 251(b).

Illinois Statutory Framework

- IBCA § 2.10(b)(3) is the IL equivalent of DGCL § 102(b)(7).
- § 2.10(b)(3) – the articles of incorporation may include a provision eliminating or limiting personal liability of *directors* for money damages for breach of fiduciary duty, other than:
  - — Breaches of the duty of loyalty,
  - — For acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law,
  - — Improper distributions (*see* § 8.65), or
  - — Any transaction from which the director derived an improper personal benefit.
- The IBCA does not yet allow for limitation of liability for *officers* like the DGCL has in § 102(b)(7).

Special Duties in M&A Transactions

- As noted previously, DE courts generally defer to the board's business judgment – M&A is one circumstance where additional review may be required, and, depending on the facts, a board may have to demonstrate fairness.
- Enhanced scrutiny (the ***Unocal*** test)
  - This level of review generally applies to defensive measures adopted by a board in response to a perceived threat.
  - ***Revlon*** duties (i.e., the duty to auction) also are often regarded as a form of "enhanced scrutiny".

Special Duties in M&A Transactions

- Entire fairness—certain circumstances surrounding a transaction may preclude a court from deferring to the board's business judgment, even where there is evidence of a robust process:
  - — Presence of a controlling or dominating shareholder, or other conflict of interest,
  - — Other evidence the board did not exercise good faith or conduct itself in a fully informed manner, without conflict.
- A court's application of the entire fairness standard is often outcome determinative for procedural reasons.
- However, even where the entire fairness standard applies, a board may be able to shift the burden of proof to the plaintiff through procedural fairness measures and, in some cases, overcome the presumptions and get the benefit of the business judgment rule.

Exception to Entire Fairness in Controller Transactions

- Kahn v. M & F Worldwide (2014) – this case established an exception to the entire fairness standard in the context of a controller transaction.
  - — Minority shareholders of a subsidiary acquired by the controlling shareholder sued the controller and the subsidiary's directors for breach of fiduciary duty.
  - — The Delaware Supreme Court held that the business judgment rule is the appropriate standard of review, *rather than entire fairness*, where a merger is conditioned on both:
    - Approval of an independent, adequately empowered special committee that fulfills its duty of care, and
    - The uncoerced, informed vote of a majority of the minority stockholders.

Sales of Control – Controlling Shareholders in M&A

- John Q. Hammons Hotels (Del. Ch. 2009) – When one class of shareholders receives markedly different merger consideration, and that class holds majority voting power, there must be significant procedural protections to preserve negotiating power of the minority for the business judgment rule to apply.
  - — Otherwise, the transaction will be subject to entire fairness review.

Sales of Control – Controlling Shareholders in M&A

- In re Delphi Financial Group (Del. Ch. 2012) – in this memorandum opinion, the Court addressed conflicts between a controlling shareholder and minority shareholders in a sale of the company.
  - — Rosenkranz, founder and CEO of Delphi, maintained control through a multiple share class structure. When selling the company, he negotiated for higher compensation for his own shares and continuation of contracts with another company he owned.
  - — The Court held that plaintiffs were reasonably likely to demonstrate at trial that Rosenkranz breached his fiduciary duties to shareholders. However, the Court refused to enjoin the merger, stating monetary damages as the preferred remedy.
  - — A word of caution – inviting a lawsuit at Delphi's sale allowed the court to delve into Rosenkranz's past decisions.

Conflicts Between Preferred and Common Shareholders

- In re Trados Incorporated Shareholder Litigation (Del. Ch. 2013) – When the interests of preferred and common shareholders conflict, the board of directors owes fiduciary duties to the common and not to the preferred.
  - In the sale of Trados, the board approved a merger price where preferred shareholders and management were paid, but common shareholders received nothing.
  - The board's decision to sell was subject to entire fairness review.
  - The Court rejected defendants' claims that preferred and common shareholders' interests were aligned because the merger resulted in the worst possible outcome for common shareholders, and they would have been better off had the merger never happened.
  - Common fact pattern – sale of a venture-backed company where preferred shareholders and management receive payment in a merger, but common shareholders receive nothing.

Conflicts Among Shareholders of the Same Class

- In re Morton's Restaurant Group, Inc. Shareholders Litigation (Del. Ch. 2013) – the Court found that a private equity firm with a 28% stake in Morton's was not a controlling shareholder, applied the business judgment rule, and dismissed the plaintiffs' shareholder challenge at the motion to dismiss stage.
  - The Court emphasized that the PE firm had not exercised undue influence over the 9-month sale process, and all of Morton's shareholders received the same consideration, which acted as a "safe harbor."
- N.J. Carpenters Pension Fund v. InfoGroup, Inc. (Del. Ch. 2011) – the Court held that Gupta, the CEO and largest shareholder (but not a majority shareholder), engaged in domineering conduct by bullying the board into approving the transaction (which arguably undervalued the corporation), and his conduct required the entire fairness standard.

Legal Standards for Control Transactions – Limits on *Revlon* Duties

- Corwin v. KKR Financial Holdings (2015) – the Delaware Supreme Court held that an uncoerced, informed shareholder vote is outcome-determinative, even if *Revlon* duties otherwise applied.
  - Justice Strine: "*Unocal* and *Revlon* are primarily designed to give stockholders and the Court of Chancery the tool of injunctive relief to address important M&A decisions in real time, before closing."
- Morrison v. Berry (2018) – the Delaware Supreme Court discussed *Corwin*, clarifying that shareholders' approval of a transaction must be fully informed before defendants may avail themselves of the business judgment rule under the *Corwin* doctrine.
  - Disclosures to shareholders must be free of material misrepresentations and omissions for the *Corwin* doctrine to apply.

Appraisal Rights in Closely-Held Corporations

- Manti Holdings, LLC v. Authentix Acquisition Company, Inc. (2021) – the Delaware Supreme Court held that shareholders can waive their appraisal rights as part of a sale, if certain conditions are met.
  - — The Court considers a series of factors, including:
    - (i) The presence of a written contract,
    - (ii) The clarity of the waiver,
    - (iii) The stockholder's understanding of the waiver's implications,
    - (iv) The stockholder's ability to reject the provision,
    - (v) The existence of bargained-for consideration, and
    - (vi) The stockholder's sophistication.
- *Manti* emphasized that the context in which the waiver arose mattered.

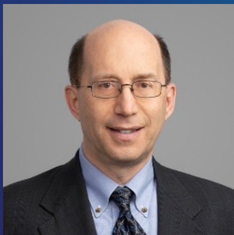
Fiduciary Duty Waivers in Closely-Held Corporations

- New Enter. Assocs. 14, L.P. v. Rich (Del. Ch. 2023) - Plaintiffs alleged that defendants breached their fiduciary duty following a merger, arguing that merger consideration was inadequate and a covenant not to sue in a drag-along provision was facially invalid.
  - The Court held that a waiver of fiduciary duties can be valid if narrowly tailored and reasonable; however, as a matter of public policy, a covenant not to sue cannot shield defendants from tort liability for intentional harm.
  - Covenants not to sue are generally enforceable under DE law, but they must:
    - Be narrowly tailored and addressed to a specific transaction that could otherwise constitute a breach of fiduciary duty,
    - Survive close scrutiny for reasonableness (*Manti* factors).
  - Here, the Court found that covenants were narrowly tailored and satisfied the *Manti* factors, and therefore, they were enforceable.
  - Despite the covenants' enforceability, the Court held that public policy prohibits contracts from insulating directors or controlling shareholders from tort or fiduciary liability where there is *intentional* wrongdoing, which the court found was plausibly alleged in this case.

Appraisal Rights and Fiduciary Duty Waivers – Practice Points

- **Appraisal rights can be contractually waived.**
  - *Manti* provides some assurance that Delaware courts will uphold the validity of appraisal rights waivers in shareholder agreements.
  - The factors in *Manti* should be satisfied to ensure that the waiver provision will be upheld – parties to the shareholder agreement should be sophisticated, informed investors who are represented by counsel.
- **Waiver provisions do not insulate parties from liability for intentional wrongdoing.**
  - *NEA v. Rich* cautions against overreliance on contractual waivers, but in many situations, such waivers may allow sophisticated parties to contract around default legal principles.
- **Post-*NEA v. Rich***
  - LLC agreements continue to allow significant flexibility to contract around default legal principles.
  - In the context of corporate shareholder agreements, practitioners can reasonably expect that a well crafted drag along provision should insulate parties from most liability absent tortious behavior.

Questions?



Jeffrey Patt
Partner, Mergers and Acquisitions
Katten

Thomas Lamprecht
Partner, Mergers and Acquisitions
Katten

PROGRAM 2: KATTEN LED

Estate and Wealth Transfer Planning for Family Business Owners

Mary Buddig
Moderator

Adam Damerow
Partner, Private Wealth
Katten

Tye Klooster
Partner, Private Wealth
Katten

Charles Harris
Partner, Private Wealth
Katten

Agenda

I. Core Estate Planning Considerations

   a) Coordination with Governing Family Business Documents

II. Federal and Illinois Estate Tax Landscape

   a) Exemption changes EOY 2025

III. Estate Tax Savings Strategies

   a) Generation-Skipping Transfer (“GST”) overview

   b) Gift to irrevocable trust

   c) Sale to irrevocable trust

I. Core Estate Planning Considerations

Core Estate Planning Documents – Basic Requirements & Examples

- Will – applies to probate assets
  - — Use "pour-over" will to distribute individual's assets at death to revocable trust, avoiding probate
- Revocable Trust – main testamentary estate planning document, avoids probate
- Power of Attorney for Property
- Power of Attorney for Health Care and HIPAA authorization
- Other considerations:
  - — Asset protection planning
  - — Planning for divorce (ex: prenuptial agreements; trusts)
  - — Insurance Planning

Core Estate Planning Considerations – Trusts Generally

- Trust: a legal relationship between two persons
  - — May be created by: 1) transfer of property to another person as Trustee during the Grantor's lifetime, 2) by will or other disposition taking effect upon the Grantor's death, or 3) some combination thereof
- Trust Agreement:
  - — Grantor sets trust rules (subject to state law)
  - — Trustee has duty to carry out the trust's terms
  - — Beneficiaries are entitled to benefit of trust assets
- Estate tax benefits
- Assets protected
  - — Generally subject to Grantor's creditors if distributable to Grantor
  - — Spendthrift provisions prevent others from having claim to trust property before distribution to a beneficiary (other than the Grantor)
    - If valid, creditors cannot access interest in trust
    - If invalid or nonexistent, court can authorize creditors to access interest

Core Estate Planning Considerations – Trust Provisions

- Can divide Powers of Trustee (optional)
  - — Investment (or Business) Advisor (directs investment of assets)
    - May treat liquid and illiquid assets differently
  - — Distribution Advisor (directs distribution decisions)
  - — Charitable Advisor (directs charitable assets)
- Can name Trust Protector (optional)
  - — Individual allocated certain powers to improve trust administration
    - Power to remove and replace fiduciaries
    - Power to amend certain trust provisions (most often administrative, but may include distributions)

Core Estate Planning Considerations – Trust Beneficiary Rights

- *Generally* (can be modified by agreement):
  - Right to know about the trust's existence (silent trust?)
  - Right to know the identities of the trustee and other fiduciaries (such as investment advisors; trust protectors; etc.)
  - Right to receive a copy of the trust instrument (what about only the portions that pertain to the beneficiary?)
  - Right to review an inventory of the trust's assets
  - Right to review accounting detailing the receipts, disbursements and distributions from the trust
  - Right to receive distributions (mandatory v. discretionary)

Importance of Document Coordination – Generally

- Estate planning provisions impacting ownership and/or control of family business interests should be coordinated with company's governing documents
  - E.g., trust provisions and transfer of company interests
- Factors may include:
  - Buy-sell and co-sale provisions
  - Transfer restrictions
  - Permissible owners
    - Temporal aspect: during life, at Grantor's death, and many years in the future
- These considerations are their own presentation

Importance of Document Coordination – S Corporation Issues

- 1 class of stock rule – voting differences disregarded
- Only certain individuals can be shareholders
  - E.g., nonresident aliens not qualified
- Only certain trusts can be shareholders
  - Grantor Trust, ESBT or QSST
- Result of violations – C corp. status and double taxation 😱

Importance of Document Coordination – Transfer of Shares at Death Example

	Shares held:		
During life:	***Individually***	***In revocable trust***	
At Grantor's death:	Probate assets "pour over" to trust	Marital trust	Residuary trust captures $12.92 M
At Grantor's spouse's death:			Discretionary trust(s) for children

II. Federal and Illinois Estate Tax Landscape

Federal and Illinois Estate Tax Landscape – Transfer Tax Considerations

- Parallel taxes
- Gift Tax (applies to transfers during life)
  - 40% tax imposed on amounts exceeding:
    - $17,000 per donee per tax year
    - $12.92 M lifetime exemption
- Estate Tax (applies to transfers at death)
  - 40% tax imposed on amounts exceeding $12.92 M
- Inheritance Tax
  - no Federal Inheritance Tax
- Generation-Skipping Transfer ("GST") Tax
  - 40% tax imposed on transfer amounts exceeding $12.92 M to "skip persons" (discussed later)

Estate Tax Landscape

- Estate (death) taxes are a looming issue for many successful business owners
- Federal estate tax exemption: $12.92 M per person* in 2023
  - — Thus, no federal estate tax due for a married couple until combined assets are over $25.84 M (exemption is portable between spouses)
  - — Federal estate tax rate: 40%
  - — *Temporarily doubled through 2025. Reverts to $5 M + inflation adjustment in 2026
- States with a separate state estate tax: IL, CT, D.C., HI, ME, MD, MA, MN, NY, OR, RI, VT, and WA
  - Illinois has $ 4 M state estate tax exemption (not portable); ~10% state estate tax rate

Trust Taxation

- Income Tax (Federal and State):
  - Grantor Trust – Grantor deemed “owner” of the trust
    - Trust taxable on Grantor’s personal income tax return
  - Non-grantor Trust – Grantor not “owner” of the trust
    - Trust is separate taxpayer and files its own tax return
      - States consider factors in determining if state income tax is appropriate
      - E.g.: Nearly all trusts created by a deceased Grantor are non-grantor trusts
- Transfer Tax:
  - A trust can be a grantor trust for income tax purposes but removed from the transfer tax system (i.e., not deemed to be “owned” by the grantor). THERE IS A MISMATCH HERE (discussed later)

III. Estate Tax Savings Strategies

Estate Tax Savings Strategies – Overview

- Lifetime gifts
  - — Outright
  - — Irrevocable trusts
    - "SLATs," "GRATs," "IDGTs," "Dynasty Trusts," "ILITs"
- Insurance planning
  - — Company owned life insurance
- Gift and sale to an irrevocable trust

Generation Skipping Transfer ("GST") Tax – Overview

- The government taxes the transfer of wealth *at each generation* and imposes an additional transfer tax on transfers that skip generations (i.e., "skip persons")
- GSTs incur a 40% GST tax on amounts that exceed the GST exemption
  - — GST tax exemption: $12.92 M (2023)
  - — E.g.: Warren Buffet leaves all his wealth at death to his grandchildren (i.e., skips his children)
    - Buffet incurs 40% estate tax on the amount exceeding $12.92 M
    - Buffet incurs 40% GST tax on the amount exceeding $12.92 M

Estate Tax Savings Strategies – GST Trusts

- "GST trusts" hold assets for the benefit of beneficiaries without causing them to be taxable in the beneficiary's estate
  - — Assets in GST trusts can grow free of further transfer tax indefinitely
    - May include long-term assets (e.g., family business; investment real estate)
- GST trusts are <u>irrevocable</u> upon creation
- Typical arrangement –
  - — Independent trustee *or* co-trustees (child beneficiary & independent trustee)
  - — Spouse, and then at Spouse's death, Child is sole lifetime beneficiary with limited power to direct assets to other beneficiaries (Grantor's descendants, charities, sometimes spouse)
  - — Trustee makes distributions for child's health, support, education, and best interests
  - — At child's death, assets are held in separate trusts for child's descendants
- GST Trusts become the "backbone" of the family's wealth

Estate Tax Savings Strategies – GST Trusts

- Restrictions on GST trusts:
  - Beneficiary does not have a right of withdrawal over trust property
  - Beneficiary does not have a general power of appointment
  - Beneficiary, if serving as trustee, cannot make distributions to himself/herself beyond health, support and education
- Best practices:
  - Require an independent trustee
  - Grant limited powers of appointment to beneficiaries where appropriate

Estate Tax Savings Strategies – GST Trusts and the Family Business

- Transfers can occur:
  - —During life via lifetime gifts to irrevocable trusts
  - —At death via transfers to irrevocable trusts
- Important considerations for family business interests held in GST trusts:
  - —Trustee succession
  - —Voting interests vs. non-voting interests
  - —Family business shareholders' agreements and transfer restrictions
    - If a family business is large enough, there may only be enough GST tax exemption to allocate a portion of company shares to the GST trusts
    - Children in business vs. those that are not

Estate Tax Savings Strategies – Gift Example

Business owners, John and Jane, are planning to sell growing company 3 years from today (married IL residents)

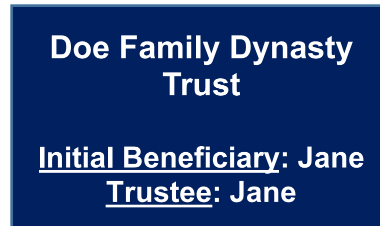
2023 Assets		Hypothetical Sale of Company in 2026	
$ 50,000,000[1]	Value of Family Company (the "Company")	$150,000,000[3]	Value of Family Company
$ 10,000,000	Other Assets	$ 10,000,000	Other Assets
-$25,840,000	Combined Federal Estate Tax Exemption	-$25,840,000	Combined Federal Estate Tax Exemption
$ 34,160,000	Net Taxable Estate	$134,160,000	Net Taxable Estate
$ 17,080,000	**Estimated Federal and Illinois Estate Taxes at the death of the survivor of John and Jane[2]**	**$ 67,080,000**	**Estimated Federal and Illinois Estate Taxes at the death of the survivor of John and Jane[2]**

Notes

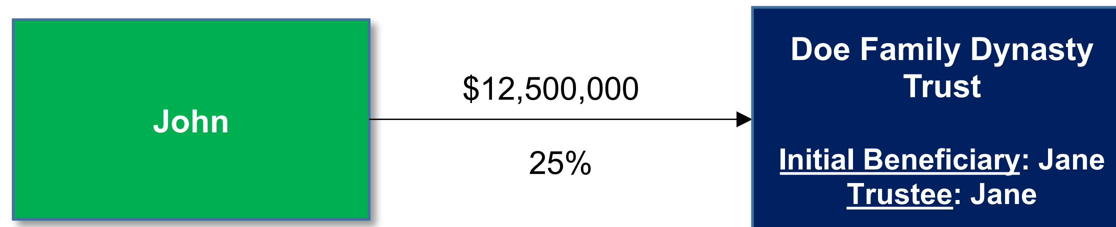
1. Based on a hypothetical $75,000,000 liquidation valuation of the company, but valued on a minority basis applying discounts for lack of marketability and control in the context of lifetime gifts.
2. The applicable federal estate tax exemption amount in 2023 is $12,920,000 per person and the Illinois estate tax exemption amount is $4,000,000 per person. The federal estate tax rate is 40% and the Illinois estate tax rate is approximately 10% (resulting in an approximate blended rate of 50%). For business owners in states without a state estate tax the tax rate is the 40% federal rate.
3. Based on a full liquidation value upon sale to a third-party purchaser, i.e., value of 100% interest in company doubles in 3 years.
4. **This example is for a company sale. The illustrated estate tax savings is the same if the family retains the company interests and grows the business.**

John Makes 2023 Gift to Doe Family Dynasty Trust

Step One: John creates the "Doe Family Dynasty Trust"[1]



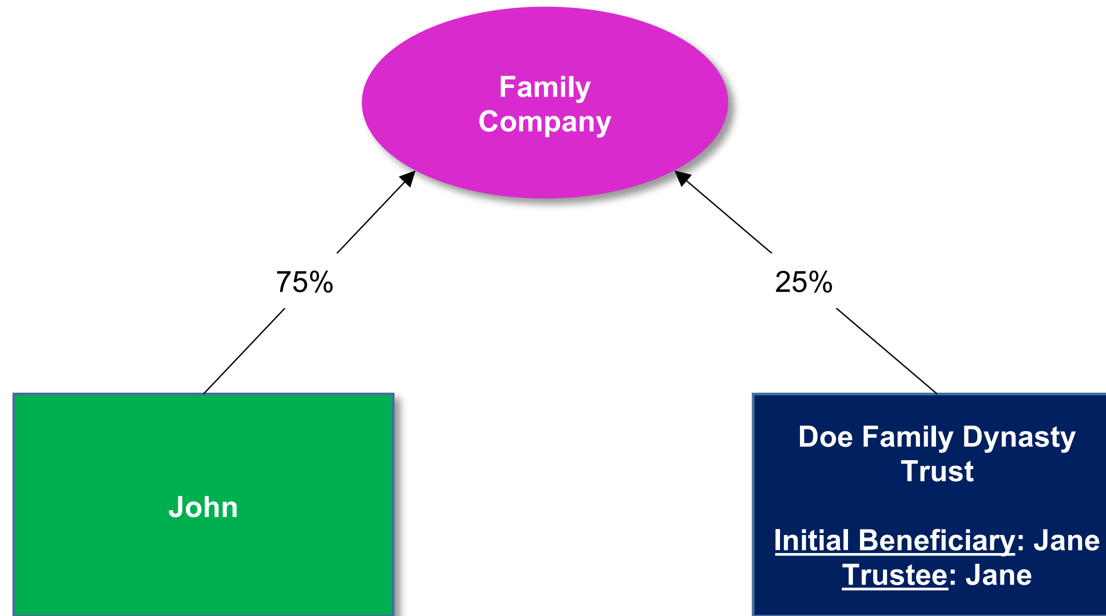
Step Two: John gifts a 25% interest ($12,500,000[2] of value) in the Company to the Dynasty Trust



Notes

1. Jane will be the initial sole beneficiary; distributions may be made for Jane's health, education, maintenance and support and her best interests (if an Independent Trustee is added). Jane will have a power over the trust to support John and Jane's children, if any, from the trust assets. The trust will be GST exempt.
2. The $12,500,000 gift will use John's gift and GST exemptions and represents a 25% interest in the Company. The gift will be reported on John's 2023 gift tax return.

Summary of Resulting Ownership of the Company in 2023



Future distributions from the Company will be distributed 75%/25% to John and the Dynasty Trust[1], respectively.

Notes

1. The Dynasty Trust will be a "grantor trust" as to John. This means that so long as John is willing to, John will pay the income taxes on the trust's behalf. This grantor trust feature offers the family a powerful way to transfer wealth to the next generation as it allows John to pay the income tax for his beneficiaries while living (without such tax payments being considered a gift).

"Fast Forward to 2026"

- Company sells to a third party for $150,000,000, resulting in the following distribution waterfall:
  - — John receives 75% of the proceeds ($112,500,000)
  - — The Dynasty Trust receives 25% of the proceeds ($37,500,000)
  - — John pays estimated income tax of $45,000,000 on the entire amount ($150M x 30% (assures $0 tax basis)), leaving John with $67,500,000 of liquidity post-sale
  - — The Dynasty Trust pays $0 in income tax and has $37,500,000 in assets
- **In summary**: John used $12,500,000 of his gift/estate tax exemption in 2023 to transfer $37,500,000 out of his taxable estate, saving his family approximately $12,500,000 in estate taxes (i.e. John removed $25,000,000 of appreciation from John's estate x 50% estate tax rate)
  - — Assets owned by the Dynasty Trust will continue to grow tax free of estate tax
  - — Thus, if the $37,500,000 in the Dynasty Trust doubled to $75,000,000 in John's lifetime, this planning would save his family an additional estimated $18,750,000 of estate taxes on the appreciation of the trust's assets

Optional Additional Pre-Transaction Planning

I. Gifts by Jane

- Jane could do similar planning to use up her gift/estate tax exemption[1], essentially doubling the potential tax savings

II. Intra-Family Sale of Company shares (prior to assumed sale to a third party in 2026)

- Even if John has exhausted his own gift/estate tax exemption, John could sell additional interests in the Company to the Dynasty Trust[2] to further maximize the benefit of pre-transaction wealth transfer planning
- E.g., John could sell another 25% of the Company to the Dynasty Trust (in exchange for a Promissory Note in the amount of $12,500,000), such that the resulting ownership would be 50% held by John and 50% held by the Dynasty Trust

Notes

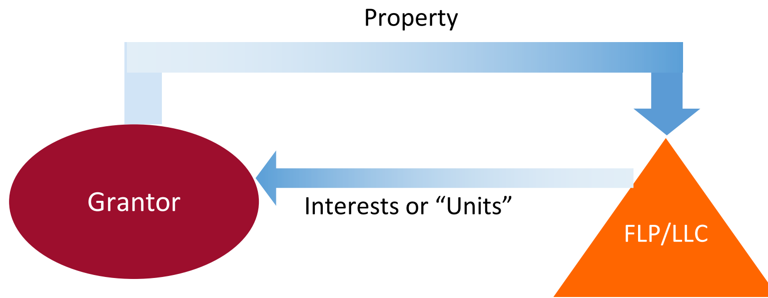
1. We would not recommend John being an initial beneficiary of Jane's irrevocable trust; typically John and Jane's children would be the initial beneficiaries.
2. The sale to the Dynasty Trust would likely be in exchange for a Promissory Note. The term of such a Note would likely be 9 years, and use the applicable federal mid-term interest rate in the month of the sale (for example: in June 2023, the mid-term AFR is 3.56%).

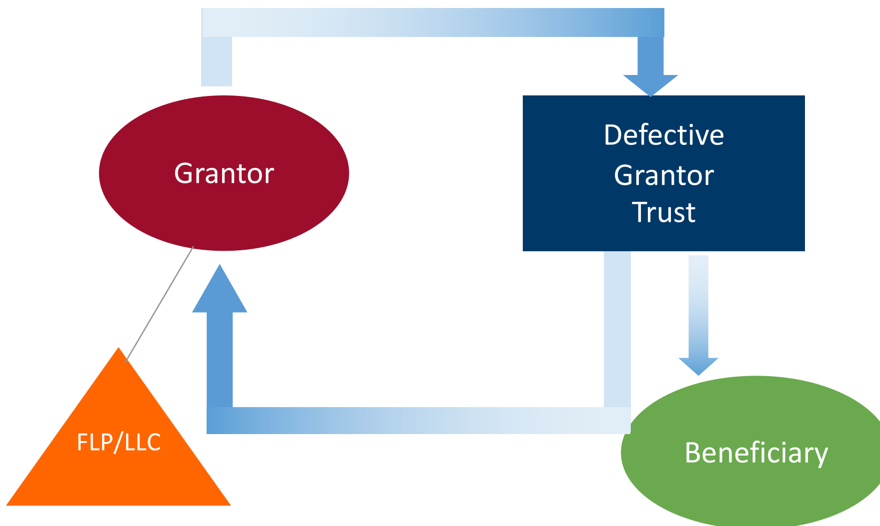
Fast Forward to 2026: John's Gift and Sale Version

- The Company sells for $150,000,000 (***same***), resulting in the following distribution waterfall:
  - John receives: ~~75%~~ **50%** of the proceeds (~~$112,500,000~~ **$75,000,000**).
  - The Dynasty Trust receives: ~~25%~~ **50%** of the proceeds (~~$37,500,000~~ **$75,000,000**).
  - John pays estimated income tax of: $45,000,000 on the entire amount ($150M x 30%) (***same***).
  - Leaving John with liquidity post-sale of: ~~$67,500,000~~ **$30,000,000**.
  - The Dynasty Trust pays: $0 in income tax (***same***).
  - The Dynasty Trust has assets of: ~~$37,500,000~~ **$75,000,000** (and owes John $12,500,000).
  - The Dynasty Trust could repay the Note: Resulting assets of John - **$42,500,000**.

- **In summary**: John used $12,500,000 of his gift/estate tax exemption in 2023 **and sold another 25% of the Company** to transfer ~~$37,500,000~~ **$75,000,000** out of his taxable estate, saving his family approximately ~~$12,500,000~~ **$25,000,000** in estate taxes.
  - Assets owned by the Dynasty Trust will continue to grow tax free of estate tax (***same***).
  - Thus, if the ~~$37,500,000~~ **$75,000,000** in the Dynasty Trust doubled to ~~$75,000,000~~ **$150,000,000** in John's lifetime, this planning would save his family an additional estimated ~~$18,750,000~~ **$37,500,000** of estate taxes on the appreciation of the trust's assets.

Estate Tax Savings Strategies – Sale to Defective Grantor Trust ("DGT")





How it Works

- Grantor establishes a DGT and funds it with a taxable gift with a value of approximately 10% of the assets being sold to the trust
- The DGT purchases appreciating assets from the grantor in exchange for a down payment (optional) and a promissory note
- The DGT repays the note with trust income or trust assets
- All items of income and deductions of the DGT, including capital gains, are taxable to the grantor
- Appreciation in excess of the initial valuation of the property, and the interest thereon, essentially passes free of transfer tax to the trust beneficiaries
- GST exemption will be allocated to the trust

Estate and Wealth Transfer Planning for Family Business Owners

Key Takeaways:

- Make sure core estate planning documents, in particular Revocable Trusts, are up to date, and trust provisions impacting family business interests are thoughtful and coordinated with company documents.
- Current federal gift, estate and GST tax exemptions will be cut in half on January 1, 2026 without further action by Congress.
- Implementing wealth transfer strategies with transfers of family business interests to irrevocable trusts can save families tens of millions of dollars in estate tax. Planning early maximizes tax savings!

Questions?

Mary Buddig
Moderator

Adam Damerow
Partner, Private Wealth
Katten

Tye Klooster
Partner, Private Wealth
Katten

Charles Harris
Partner, Private Wealth
Katten

10 Minute Break

PROGRAM 3: FROM A TRENDING PODCAST

Developing and Expanding a Family Office

Robin Letchinger
Partner, Chair of Family Enterprise Practice

Josh Kanter
CEO and Founder leafplanner
President of Chicago Financial, Inc.

Saul Rudo
Partner, Transactional Tax
Katten

Agenda

- Introductions
- Quick survey
- Family office services
- Outsource v. in-house
- Types of family office structures
- When a family should and should not create a family office

Family Office Services

- Investment management
- Data aggregation and reporting
- Risk assessment and management
- Property management
- Estate and wealth/tax planning
- Investment vehicles, trusts, and family partnerships' administration
- Philanthropic planning and administration
- Lifestyle/concierge services
- Family office strategy and management
- Family and office governance
- Family engagement and education, including family members' financial literacy
- Creation and continuation of family legacy, philosophies, and values to future generations

The menu of service offerings depends on family members' needs and goals*

Strategic Wealth Planning	Legal & Tax	Accounting & Finance	Investments	Banking & Insurance	Philanthropy	Family & Lifestyle	Family Office Management
Wealth Transfer Planning	Tax Planning	Bookkeeping	Global Custody	Checking & Savings Accounts	Tailored Charitable Giving Strategies	Family Meetings & Education	Human Resources
Financial Planning	Tax Compliance	Budgeting & Cash Flow Analysis	Investment Strategy & Asset Allocation	Lines of Credit & Credit Cards	Family Foundation Management	Family & Family Office Governance	Policies & Procedures
Investment Structure & Design	Estate Plan Reviews	Financial Controls	Execution of Investment Plan	Bill Payment	Investment of Philanthropic Assets	Private Employee Management	Coordination of Advisor Team
Trusteeship (serving as trustee, trust administration, executorship)	Contract, Litigation & Reputation Management	General Ledger, Trust & Partnership Accounting	Investment & Manager Due Diligence	Insurance Selection	Involving the Family in Charitable Giving	Property Management & Maintenance	Risk & Opportunity Management
Business Management	Pre-Nuptial Education & Planning	Data Aggregation & Reconciliation	Manager Selection	Payment of Premiums & Claims Processing	Grant Review Due Diligence	Travel & Concierge Services	Technology & Cybersecurity
Succession Planning	Fiduciary Oversight	Consolidated Financial Reporting	Performance Reporting	Insurance Reviews	Charitable Benchmarking	Special Asset Management (Art, Yachts, Airplanes)	Special Projects

*Northern Trust

Outsource v. In-House

- Expertise

  sometimes a service requires a level of knowledge or expertise that is not available in-house and is only needed periodically or sporadically, such as estate planning or a tricky tax issue.

- Access to depth and back up

  having a team of people who are familiar with and knowledgeable about the family's situation is, for many, a worthwhile investment.

- Cost-effectiveness

  there are times when it costs less to outsource a service than it would to hire/pay internal resources, such as tax preparation or payroll.

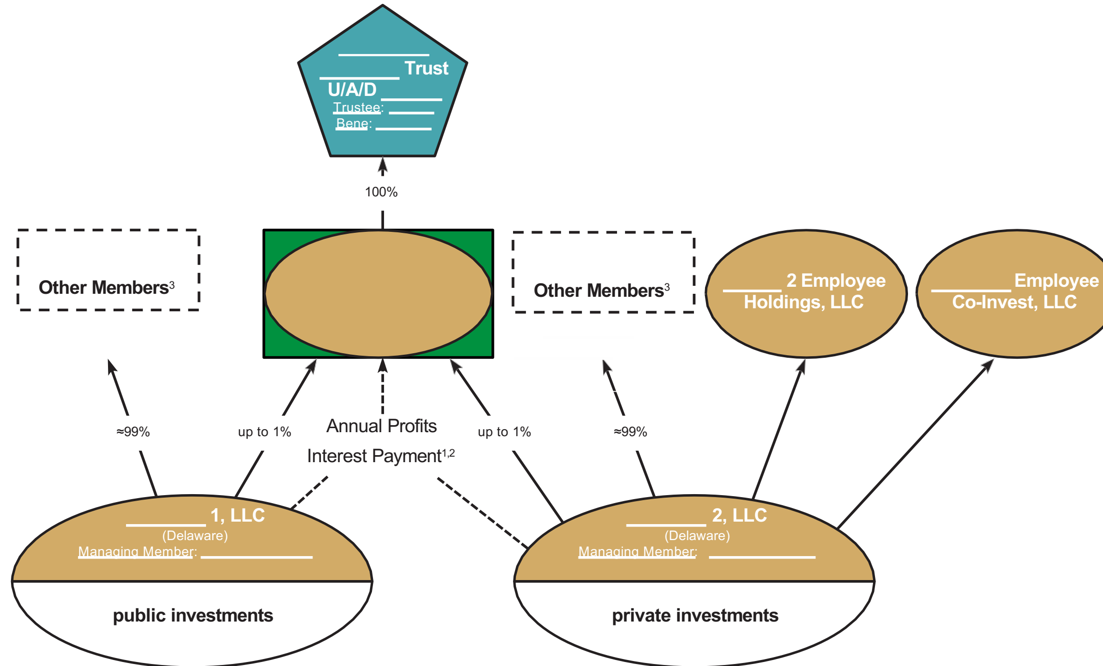
Family Office Structures

- Embedded

- SFO/VFO
  - LLC
  - C Corp
  - Profits interest (“Lender”) structure

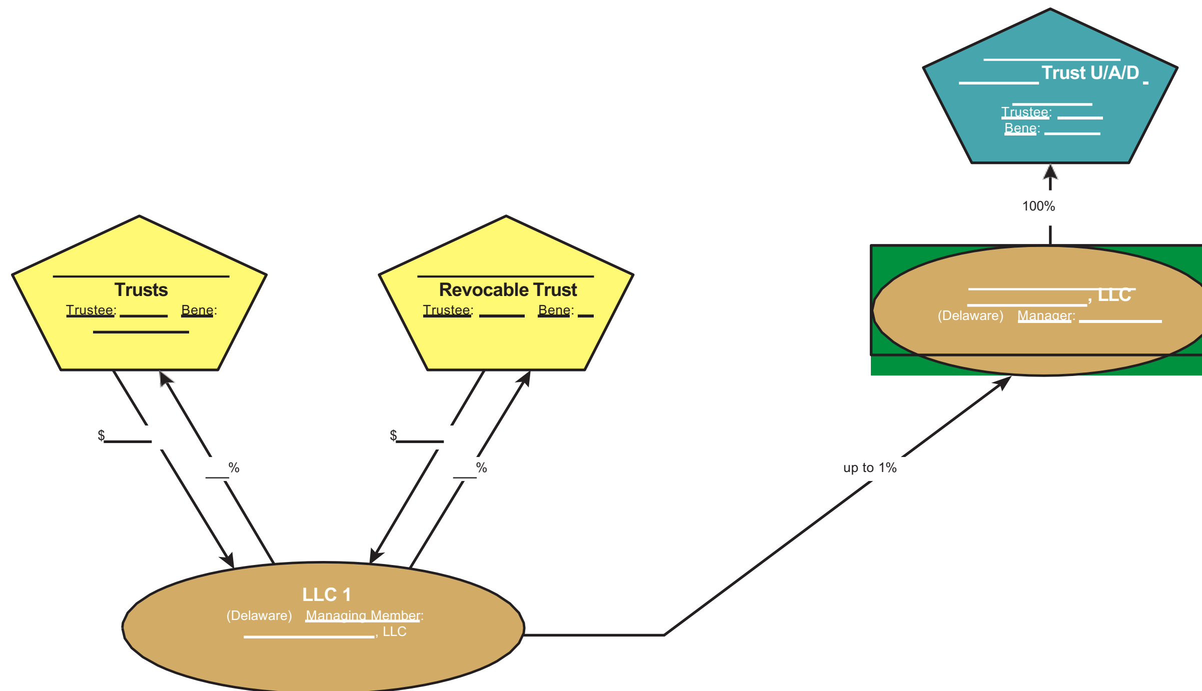
—MFO

Sample Single Family Office "Lender" Structure



1. Single family office manages investing LLCs and will employ various persons and engage third-party advisors to assist in its investment management business. Annual profits interests payments may equal or exceed funds necessary for SFO to satisfy its necessary operating expenses (e.g., wages, third-party accounting, legal and investment advisory fees). These payments will reduce taxable income that is allocated to members of the investing LLCs.
2. Investing LLCs must have net income to pay profits interest payments to the SFO. To the extent profits interest payments and other assets are insufficient to meet the SFO's operating expenses, it could borrow necessary funds.
3. Members of the investing LLCs must be limited to "family clients" to preserve eligibility for the "family office" exclusion under the Investment Advisers Act.

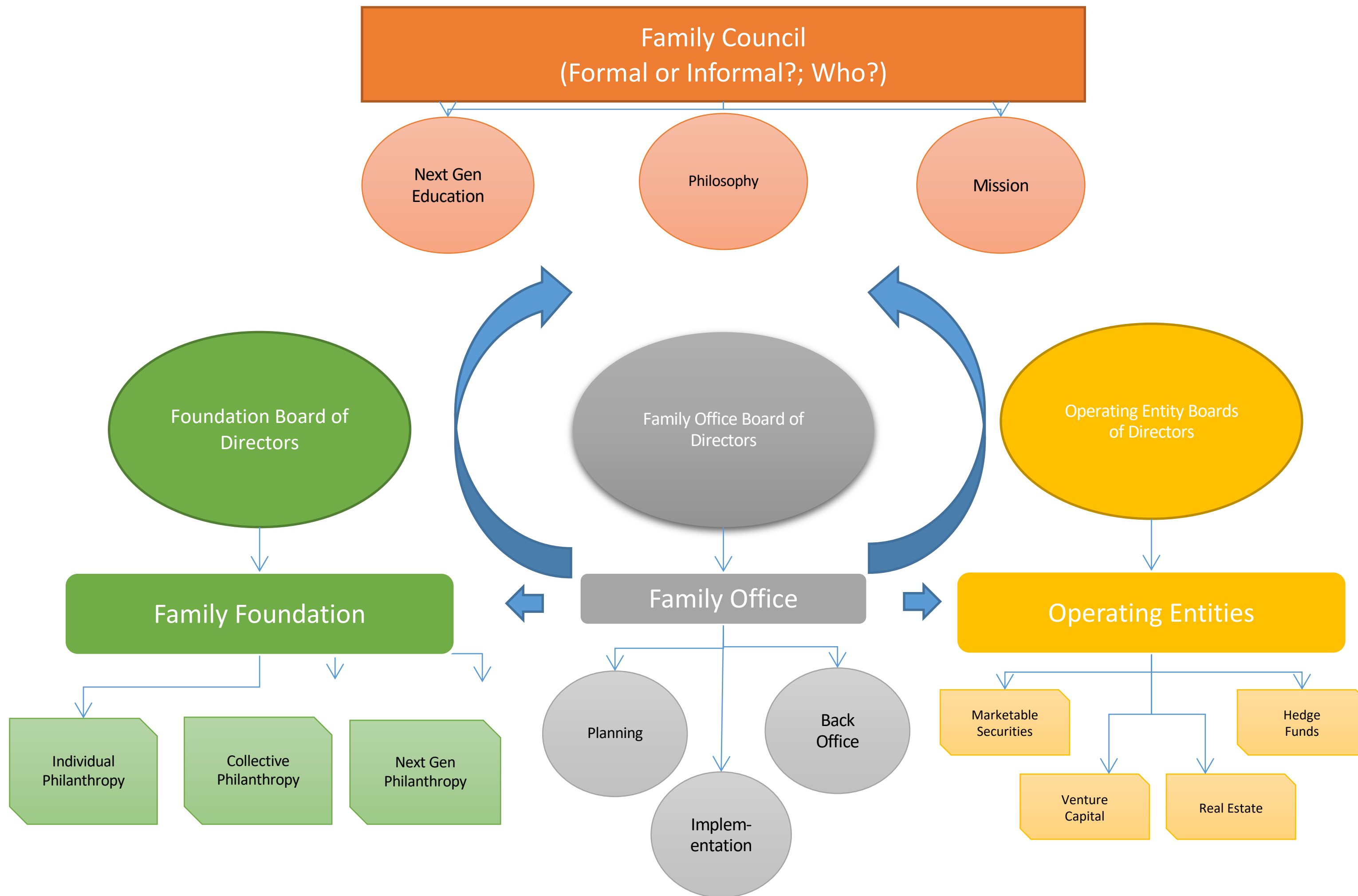
Investments by Family Clients of the Family Office



- Various investing LLCs may be established under the management of the SFO to access different investment opportunities and to facilitate participation by different groups of "family clients" with varying investment needs and objectives, as well as to facilitate participation by different PM teams.

- To be eligible for the family office exclusion, the SFO entity also must be (a) wholly owned by "family clients" and (b) exclusively controlled by one or more family members or family entities (such as a qualifying family trust).

Sample Family Governance Structure with a Single Family Office



When Should a Family Create a Family Office and What are Some of the Considerations in Doing So?

—Liquidity event (e.g., selling of an operating business)

- identifying who will be paying for and who will be providing the family office services that previously were paid for/done by the operating business

—Complexity of wealth/size of family and its shared assets over multiple generations

- establishing the value-add of the family office for the next generation

—Pulling an embedded family office out of an existing operating business

- creating a compensation plan for professionals in the family office

Why Are You Really Doing This?

- What is the problem the client is solving for?
- What services does the client want to offer and to whom?
- What is the cost, now and into the future, and the difficulty of reversing course?
- How critical is a truly integrated solution?

Potential Reasons to Create a Family Office

- Education of owners and future owners
- Financial security for owners
- Confidentiality of information
- Continuity of the family
- Customization of financial services
- Coordination of advisors
- Development of wealth strategy and investment strategy
- Purchasing power to access products and reduce fees
- Alignment of interests and integration of goals
- Coordination of trustee and beneficiary responsibilities

How Big Do I Have to be to Have a family Office?

- No formula
- Adding value and family perceives value being added
- Complexity factors

  —households/family members per household

  —investable assets

  —advisor relationships

  —accounting entities

  —tax returns

When a Family Should Not Create a Family Office

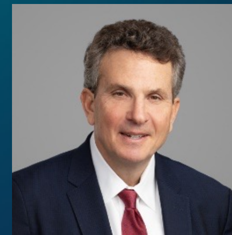
- Cannot justify the cost
- Family doesn’t want to
- Does it make sense not just now but in 5, 10, 15, 25, 50 years
- Alternatives exist

DEVELOPING AND EXPANDING A FAMILY OFFICE

Questions?

Robin Letchinger
Partner, Chair of Family Enterprise Practice

Josh Kanter
CEO and Founder leafplanner
President of Chicago Financial, Inc.



Saul Rudo
Partner, Transactional Tax
Katten

PROGRAM 4: CASE STUDY

Lessons from Ethics Counsel

Elizabeth Lewis
General Counsel
Tutlewax, Inc.

Tom Luetkemeyer
Partner
Hinshaw & Culbertson

Matt Henderson
Partner
Hinshaw & Culbertson

Who is the client?

- Rule 1.13: Organization as Client
  - (a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

* * *

  - (f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

When is it OK to represent the Company and an Employee?

- Rule 1.13: Organization as Client
  - (a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

* * *

  - (g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

When is it OK to Represent the Company and an Employee? (Cont.)

- Rule 1.7: Conflict of Interest: Current Clients
  - a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
  - (1) the representation of one client will be directly adverse to another client; or
  - (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

An Ethical Issue Arises – Now What?

- Where should an internal GC look for ethics counsel?
- What is the difference between ethics counsel and professional liability claims counsel?

How Does the In-house GC Protect the Confidentiality of Ethics Advice?

- Rule 1.6: Confidentiality of Information
  - (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).
- Evidentiary Attorney-Client Privilege
  - Only communications between attorney and client for purpose of seeking legal advice and are expressed in confidence.
  - Legal advice versus business advice

Professional Liability Insurance Considerations

- If the in-house GC makes a report to a professional liability insurance carrier, does that have to be disclosed to the company client?
- If the in-house GC takes advantage of an advice service offered by a professional liability insurance carrier, does that have to be disclosed to the client?

In-house Counsel Professional Liability Insurance

- D&O Insurance – Business

- Employed Lawyers Professional Liability Insurance – Legal
  - Attorneys and Paralegals
  - Cover practice given global business environment
  - Moonlighting – volunteering, parish, school

- Contractor
  - CBA Administrators - https://www.cbainsurance.org/
  - Request employer purchase 36-month tail policy

In-House Counsel Ethics Resources and Advisory Opinions

Chicago Bar Association

- **Ethics Opinions**
- https://www.chicagobar.org/chicagobar/CBA/Resources/Ethics_Opinions/CBA/Resources/Ethics_Opinions.aspx?hkey=8eddda09-ac88-492f-abdf-7b5a3139652e
- The CBA's Professional Responsibility Committee authors ethics opinions interpreting the Illinois Rules of Professional Conduct for members. The procedures for requesting an opinion from the Committee are as follows: 1) Any member may call or write to the Government Affairs Department to request an opinion. 2) All inquiries should be submitted in writing to the Government Affairs Department via fax at 312-554-2054, email (jvyverberg@chicagobar.org), or mailed to The Chicago Bar Association, c/o Government Affairs Department, 321 S. Plymouth Ct., Chicago, IL 60604.

The Committee issues legal ethics opinions as a public service to aid lawyers in interpreting the Illinois Rules of Professional Conduct. The opinions represent a composite judgment of a majority of those members of the Committee voting on the opinions and do not constitute an official act of The Chicago Bar Association. The opinions are not binding upon the Attorney Registration and Disciplinary Commission or on any court and should not be relied upon as a substitute for legal advice. Please be advised that the Professional Responsibility Committee issues advisory opinions only where the inquiry does not pertain to a pending matter or pending litigation.

Illinois State Bar Association

- **ISBA Ethics Infoline** members can call: 217.747.1452
- **ISBA Advisory Opinions on Professional Conduct** (Illinois State Bar Association (ISBA) Ethics Advisory Opinions) are prepared as an educational service to members of the ISBA. While the opinions express the ISBA interpretation of the Illinois Rules of Professional Conduct and other relevant materials in response to a specific hypothesized fact situation, they do not have the weight of law and should not be relied upon as a substitute for individual legal advice. For more information, call the ISBA Legal Department at (217) 525-1760 or (800) 252-8908.

- **Email Discussion Group**
- The Ethics community in ISBA Central is available for discussions about ARDC rules and procedures, cases, bar regulation, professionalism, and related topics.

https://www.isba.org/ethics/bysubject/Corporate%20and%20In-House%20Counsel

- **ISBA Ethics Opinions on Corporate and In-House Counsel**
- Duties of in-house lawyer when confronted with internal fraud or criminal conduct that could be imputed to the organization. : Opinion # 20-02
- In-house counsel representing multiple subsidiaries of same corporate parent : Opinion # 17-05
- Practice before the U.S. PTO by non-Illinois licensed lawyers : Opinion # 15-01
- In-house corporate lawyer may not provide legal services to the corporate employer's customers : Opinion # 14-03
- Lawyer for corporation related to corporate president and principal shareholder : Opinion # 95-01
- Claim for portion of in-house lawyer's salary in mortgage foreclosure : Opinion # 768
- **Other ISBA Resources**
- ISBA Standing Committee on the Attorney Registration and Disciplinary Commission
- ISBA Standing Committee on Professional Conduct

American Bar Association

- You can find articles and opinions on inhouse counsel ethics at:
- https://www.americanbar.org/topics/ethics/ and
- https://www.americanbar.org/groups/professional_responsibility/publications/ethics_opinions/

- A few ABA Articles related to Inhouse Counsel ethical practice:
- https://www.americanbar.org/groups/intellectual_property_law/publications/landslide/2017-18/november-december/attorney-client-privilege-inhouse-counsel/
- https://www.americanbar.org/groups/professional_responsibility/committees_commissions/commission-on-multijurisdictional-practice/mjp_comm_acca2/

ARDC

- The **Ethics Inquiry Program** was created by the ARDC to assist attorneys and the public when they have general questions about a lawyer's professional responsibilities or attorney disciplinary case law. The Program provides research assistance and guidance regarding ethics issues and the Illinois Rules of Professional Conduct through telephone consultations. The service is free of charge. The goal of the Program is to help lawyers understand their professional obligations and assist them in resolving important issues in their practice. The Program provides lawyers with information about professional responsibility law, legal precedent, bar association ethics opinions, law review articles and practical guidelines. Callers may remain anonymous if they choose. Further, neither the fact that an inquiry has been made nor the substance of the inquiry or any response is admissible in any attorney disciplinary proceeding. To protect both the caller and, if applicable, the caller's client, factual information should be presented in the hypothetical form.
- https://www.iardc.org/EducationAndOutreach/EthicsInquiryProgram
- Consultations only by telephoning: (312) 565-2600 or (800) 826-8625 (within Illinois).
- The ARDC's hours of operation are from 9:00 a.m. to 5:00 p.m., on all days except Saturday, Sunday and Commission Holidays.
- Illinois Supreme Court Illinois Rules of Professional Conduct
- Illinois Attorney Registration and Disciplinary Commission

Questions?

Elizabeth Lewis
General Counsel
Tutlewax, Inc.

Tom Luetkemeyer
Partner
Hinshaw & Culbertson

Matt Henderson
Partner
Hinshaw & Culbertson

Networking Lunch

PROGRAM 5: CASE STUDY

Practical Considerations & Hybrid Roles

Laurel Bellows
Founding Managing Principal
The Bellows Law Group

Lauren Novak
CHRO and Employment Counsel
at Corrugated Supplies Company

PRACTICAL CONSIDERATIONS & HYBRID ROLES

Questions?

Laurel Bellows
Founding Managing Principal
The Bellows Law Group

Lauren Novak
CHRO and Employment Counsel
at Corrugated Supplies Company

PROGRAM 6: KATTEN LED

Corporate Transparency Act

Caitlin Kelly
Associate, Private Wealth
Katten

Daniel Cotter
Attorney and Counselor
Howard & Howard

Agenda

- Background and Relevant Timeline
- Four Elements:
  - What is a Reporting Company?
  - Who are its Beneficial Owners?
  - Who are its Company Applicants?
  - What Beneficial Ownership Information is required to be reported?
- Penalties and Safeguards
- Next Steps:
  - Family Business-Specific Questions
  - Recommendations for Compliance

Background

- The Corporate Transparency Act ("CTA") (31 USC § 5336) requires "reporting companies" to report "beneficial owners" and "company applicants" to the U.S. Treasury Department's Financial Crimes Enforcement Network ("FinCEN").
- Purpose*: "Requiring entities to submit beneficial ownership information ("BOI") to FinCEN and providing timely access to this information to law enforcement, financial institutions, and other authorized users is intended to help combat corruption, money laundering, terrorist financing, tax fraud, and other illicit activity."
- "The ultimate goal of this regulatory proposal is to combat, to the broadest extent possible, the proliferation of anonymous shell companies or other opaque corporate structures."

* Per FinCEN's Fact Sheet on its Notice of Proposed Rulemaking (December 2021)

Timeline

- **January 1, 2021**: CTA was enacted as part of the Anti-Money Laundering Act of 2020 within the National Defense Authorization Act for Fiscal Year 2021, H.R. 6395 (“NDAA”).
  - Section 6403 of the CTA amends the Bank Secrecy Act by adding a new provision entitled “Beneficial Ownership Information Reporting Requirements” (31 USC § 5336).
- **April 5, 2021**: FinCEN issued an Advanced Notice of Proposed Rulemaking (“ANPRM”) regarding Beneficial Ownership Information Reporting Requirements (“Reporting Requirements”), requesting public comment on many questions related to the implementation of the CTA.
- **December 7, 2021**: FinCEN then issued a Notice of Proposed Rulemaking (“NPRM”) regarding Reporting Requirements, Proposed 31 CFR Part 1010.380.
- **February 7, 2022**: Public comments to the Proposed Regulations regarding Reporting Requirements due to FinCEN; FinCEN received over 240 comments.
- **September 30, 2022**: Final Regulations by Treasury published in the Federal Register.

Timeline

- **November 15, 2022**: Lawsuit filed by the National Small Business Association, challenging the constitutionality of the Corporate Transparency Act, National Small Business United et al. v. Yellen et al., U.S. Northern District of Alabama 5:22-cv-01448 (November 15, 2022) (still pending).
- **December 15, 2022**: FinCEN issued a NPRM regarding Beneficial Ownership Information Access and Safeguards, and Use of FinCEN Identifiers for Entities ("Access Rules"), Proposed 31 CFR Part 1010.955.
- **February 14, 2023**: Public comments to the Proposed Regulations regarding Access Rules due to FinCEN.
- **Anticipated by End of 2023**: Final Regulations on Access Rules are anticipated to be issued by the end of 2023.
- **November 2023**: Third tranche of proposed regulations which will revise the existing Customer Due Diligence Rules applicable to banks/financial institutions are anticipated to be issued by FinCEN in November 2023, according to the Regulatory Agenda.
- **January 1, 2024**: Effective date.

Four Elements

- The CTA requires a "**Reporting Company**" to disclose **specific information** regarding (1) the company itself (per 31 CFR 1010.380)(b)(1)), (2) its "**Beneficial Owners**" and (3) "**Company Applicants**" to FinCEN. 31 USC § 5336(b)(1) & (2).

Reporting Companies: Generally

- Domestic: Corporations, Limited Liability Companies, or other similar entities created by the filing of documents with a US State or Tribal Office. 31 USC § 5336(a)(11)(A).
  - Includes Limited Partnerships, Limited Liability Partnerships, and Business Statutory Trusts
  - Common Law Trusts are not Reporting Companies; but are includable as Beneficial Owners, where applicable.
  - Includes entities formed in US territories (e.g., USVI)
- Foreign: International Corporations, Limited Liability Companies, or other similar entities that are registered to do business in the United States

Reporting Companies: Exemptions

- 23 Current Exemptions (*See* 31 USC §5336(a)(11)(B)(i)–(xxiii)), including:
  - —**Large Operating Businesses**: Taxable entities that have greater than 20 full-time employees in the US, have a physical operating presence in the US, and filed a federal income tax return with more than $5m in gross receipts or sales (aggregate) for the prior year. 31 CFR 1010.380(c)(2)(xxi).
  - —Family Offices are not specifically exempted, <u>but</u> certain **registered Banks* and Pooled Investment Vehicles** are exempt. 31 CFR 1080(c)(2)(iii); 31 CFR 1010.380(f)(7); 31 CFR 1080.380(c)(2)(xviii).

  * As defined under Section 3 of the Federal Deposit Insurance Act, Section 2(a) of the Investment Company Act of 1940, or Section 202(a) of the Investment Advisors Act of 1940

Reporting Companies: Subsidiary Exemption

- **Subsidiaries that are controlled or wholly owned**, directly or indirectly, **by certain exempt entities** (including Banks or Large Operating Businesses). 31 CFR 1010.380(c)(2)(xxii).
- Example:
  - —A Reporting Company is **owned solely** by a trust, of which an Exempt Entity is the trustee.
  - —The Reporting Company most likely falls into this subsidiary exemption, would be an exempt entity and would not have a reporting requirement.
    - The ownership interest in the Reporting Company is wholly owned by a trust, and therefore by the trustee – which is an exempt entity.

Reporting Companies: Subsidiary Exemption

- **<u>Note</u>**: In the previously discussed example, the ownership interest in the Reporting Company was wholly owned by the trust.
- If the trust, of which an Exempt Entity is the trustee, has a 90% ownership interests in the Reporting Company, with the remaining 10% ownership interest attributed to another trust that does not have an exempt entity as the trustee, the Reporting Company would still be reportable.
- In this scenario, it looks like the Exempt Entity would need to report, as trustee of the trust.
  - — With no clear instruction, there would potentially need to be an individual at the Exempt Entity for whom their information is submitted, as the a Beneficial Owner of the Reporting Company.

Beneficial Owners

- "Beneficial Owner" is an **individual** who, directly or indirectly, either (1) exercises "**substantial control**" over the reporting company or (2) "**owns or controls**" **at least 25% of the "ownership interests"** of the reporting company. 31 USC § 5336(a)(3); 31 CFR 1010.380(d).

  A. Substantial Control Test: Individual who exercises "substantial control" over a Reporting Company.

  B. Ownership Test:

  - Individual, if any, who owns 25% or more of a Reporting Company, or
  - Individual, if any, who controls 25% or more of the ownership interests of a Reporting Company.

Beneficial Owners: Exceptions

- Minor Children (but parent/guardian information is instead reported).
- Individuals *acting* as nominees, intermediaries, custodians, or agents.
- Employees acting solely in such capacity and not as Senior Officers.
- Individuals with a future interest (e.g., inheritance) in ownership of a Reporting Company.
- Creditors of a Reporting Company (unless they otherwise meet the Ownership Test).
  - *See* 31 USC § 5336(a)(3)(B); 31 CFR 1010.380(d)(3).

Beneficial Owners: "Substantial Control"

- The Substantial Control test is a fact based analysis.
- In order to determine whether an individual exercises substantial control over a reporting company, look for any of the following factors:
  - — Senior Officer: Individual holding the position of (or exercising authority of) President, CEO, CFO, COO, GC, or similar officer of a Reporting Company;
  - — Individual who has the authority to appoint or remove Senior Officers or a majority of the Board of a Reporting Company; or
  - — Individual who has the power to direct or control important decisions of a Reporting Company (e.g., amendments to Governing Docs; selection or termination of business lines).
    - *See* 31 CFR 1010.380(d)(1)(A) –(C).
- Catch-All: Individual who has any other form of substantial control over a Reporting Company.
  - — *See* 31 CFR 1010.380(d)(1)(D).

Beneficial Owners: "Substantial Control", Cont'd

- "Substantial control" can be exercised directly or indirectly, including through an entity that separately exercises substantial control over the reporting company.
- "An individual may directly or indirectly, **including as a trustee of a trust**, exercise substantial control over a Reporting Company through a variety of means, including through **<u>board representation</u>**."
  - *See* 31 CFR 1010.380(d)(1)(D)(ii).
- The inclusion of the above Final Regulation alludes to the idea that some managers / directors on a board of a trustee could have "substantial control".

Beneficial Owners: “Ownership Test”

- “Total Ownership Interests”, including:
  - — Capital equity interests
  - — Profits Interests
  - — Convertible Instruments
  - — Catch-All
    - 31 CFR 1010.380(d)(2)(i).
- An individual’s “total ownership interests” is calculated by comparing said interests to the total outstanding ownership interests of the reporting company. 31 CFR 1010.380(d)(3)(iii).
- For purposes of the Ownership Test, no difference between Voting Ownership and Non-Voting Ownership.
- Joint ownership (31 CFR 1010.380(d)(3)(ii)(A))
- Power of Attorney (31 CFR 1010.380(d)(3)(ii)(B))

Beneficial Owners: "Ownership Test", Cont'd

- Under the Ownership Test, if a common law trust is an owner of an applicable Reporting Company, the analysis looks through to these specific **individuals** (31 CFR 1010.380(d)(3)(ii)(C)):
  - —A beneficiary, if such beneficiary (i) is the sole permissible recipient of income and principal; or (ii) has the right to demand distributions or withdraw substantially all trust assets.
  - —Grantors/Settlors, if he/she has the right to revoke the Trust or otherwise withdraw the assets of the Trust.
  - —Trustees or other individual(s) with the authority to dispose of trust assets.

Beneficial Owners: "Ownership Test", Cont'd

- "Other individual(s) with the authority to dispose of trust assets"
  - —Despite numerous comments requesting clarification, the Final Regulations do not provide specific transparency with respect to what specific individuals fall into the category of "other individuals who can dispose of trust assets," (e.g., Trust Protectors, Business Advisors, Distribution Committees, Investment Advisors)
  - —"In addition to trustees, the final rule specifies that other individuals with authority to control or dispose of trust assets are considered to own or control the ownership interests in a reporting company that are held in trust."

Reporting Companies Owned By Trusts

- Likely scenarios where Reporting Companies are wholly owned by Trusts:
  - The Settlors/Grantors of a Revocable Trusts will likely constitute Beneficial Owners under the Ownership Test.
  - In a scenario where there is an Irrevocable Trust where the sole beneficiary who holds a right to income and principal, the beneficiary will likely constitute a Beneficial Owner.
  - Where Settlors'/Grantors' have right to remove and replace a trustee arguably causes such Settlors/Grantors to meet the Substantial Control Test.

Special Rule:
Reporting Company Owned by an Exempt Entity

- If one or more exempt entities:
  - —has or will have a direct or indirect ownership interest in a reporting company, **AND**
  - —an individual is a beneficial owner of the reporting company exclusively by virtue of the individual's ownership interest in such exempt entities, then
- The beneficial ownership report may include the names of the exempt entities in lieu of the individual's information.
- Where the Special Rule does not apply, an individual may directly or indirectly control an ownership interest of a Reporting Company through any relationship, including as trustee of the trust or other individual (if any) with the authority to dispose of trust assets.

Special Rule

- The Special Rule can be interpreted as a very narrow exception.
- Example:
  - —If an exempt entity is acting as a manager and/or the trustee of a trust and as such, has ownership interest in a reporting company (first part of the Special Rule is satisfied).
  - —However, the second section – an individual is a Beneficial Owner of the Reporting Company solely because s/he is an owner of such exempt entity – most likely does not apply.
    - In the entity’s case, there (most likely in routine trust/trusteeship relationship) is no individual that is a Beneficial Owner of the Reporting Company because of his/her ownership interest in the entity.
    - The Special Rule would not apply here.

Company Applicants

- Up to two Individuals:
  - — Individual who files the incorporation, formation, or other creation documentation with a US State (or, if a foreign Reporting Company, files US registration documentation) 31 USC § 5336(a)(2).
  - — Individual who is primarily responsible for directing or controlling such filings if more than one individual is involved in the filing of the document. 31 CFR 1010.380(e).
- **Includes Attorneys and Paralegals**.

Beneficial Ownership Information

- Specific Information to Be Reported on:
  - Reporting Company;
  - Beneficial Owners; and
  - Company Applicants.
- *See* 31 USC § 5336(b)(2); 31 CFR 1010.380(b).

Beneficial Ownership Information: Reporting Company

- 31 CFR 1010.380(b)(1)(ii) requires Reporting Companies to provide:
  - Entity name (including DBAs)
  - Business Street Address
  - Jurisdiction of formation (or, if a Foreign Reporting Company, jurisdiction of US registrations)
  - Unique identification number (e.g., FEIN or FinCEN identified number)
  - Beneficial Owners
  - Company Applicants

  Note: No instruction has been provided about the reporting requirements related to the assets or valuation of assets held by the Reporting Company.

Beneficial Ownership Information: Beneficial Owners and Company Applicants

- 31 CFR 1010.380(b)(1)(ii) requires the following information for each Beneficial Owner and Company Applicant be reported:
  - — Full legal name
  - — Date of birth
  - — Current address – Beneficial Owners vs Company Applicants
  - — Unique identification number from an acceptable identification document (e.g., Passport) and image of such document
    - Upon request, FinCEN will issue a unique FinCEN identifier that can be included on subsequent filings instead of providing the foregoing information each time
    - **Burden shifts from Reporting Company to the holder of the FinCEN identifier to keep his/her information up to date.**

Reporting

- Entities formed before January 1, 2024: All Reportable Information required to be submitted to FinCEN not later than January 1, 2025.
  - But: no requirement to submit information re: Company Applicants.
- Entities formed on or after January 1, 2024: All Reportable Information required to be submitted to FinCEN within 30 calendar days of formation.
- Thereafter, updates to reportable information due within 30 calendar days (e.g., 30 days to report change of a Manager of an LLC or **gift** of 25% of the ownership of a Reporting Company).
- FinCEN will create a filing form.
- *See* 31 CFR 1010.380(a).

Penalties

- An individual is considered to have failed to report complete or updated BOI if such person failed in their personal responsibility to report, directs or controls another person with respect to any failure to report, or is in substantial control of a Reporting Company when it fails to report.
- Standards for Penalties:
  - — Willfully provide, or attempt to provide, false or fraudulent beneficial ownership information; or
  - — Willfully fail to report complete or updated beneficial ownership information.
  - — $500 per day (max $10,000); potential criminal liability (2 years jail time).
- The CTA places responsibility on Reporting Companies to submit and update accurate information.
- Liability extends to Senior Officers of the Reporting Company at the time of the failure to report.

Issues Collecting Beneficial Ownership Information

- What options does a Reporting Company have if a beneficial owner/other controlling party refuses to give their information or authorize the release of their information?
  - — Nonjudicial settlement agreements to release Reporting Company from not providing information they cannot obtain.
    - Would this provide real protection? "Drafting around" the law.
  - — Petition for Instructions through court involvement.
    - Would a court be willing to get involved? At what level? Jurisdiction issues?
- Can this issue be avoided altogether when the client/trust relationship is first set up (i.e. collect the beneficial ownership information upfront and disclose to the clients at that time said information will be disclosed pursuant to the CTA)?

Penalties: Safe Harbor

- A person shall not be subject to civil or criminal penalty if:
  a) the person has reason to believe that any report submitted by such person contains inaccurate information, and
  b) such person voluntarily and promptly, and in no case later than 90 days after the date on which the person submitted the report, submits a report containing corrected information.
- *See* 31 USC § 5336(h)(3)(C).
- The Safe Harbor is not available if an individual knowingly submitted false information in the original report, with the purpose of evading the reporting requirements. 31 USC § 5336(h)(3)(C)(i)(II)(bb).

Access

- **US Federal Agencies** engaged in national security, intelligence, or law enforcement activities where the beneficial ownership information would be used in connection with such activities. Such federal agency would then have access to search the FinCEN database (subject to audit by FinCEN).
- **State, local, and tribal law enforcement agencies**, provided that a court of competent jurisdiction rules that such agency should be allowed to access the beneficial ownership information. Such agency will then have access to search the database.
  - — Such agency will have to upload a document from the court of competent jurisdiction for FinCEN review prior to being granted access.

Access, Cont'd

- **Foreign law enforcement** requesters may be granted limited access. Such foreign requester will need to submit their request to intermediary US Federal Agencies and must show that (1) the foreign law enforcement requester made a request under an international treaty, agreement, or convention, or (2) the request was otherwise made by law enforcement authorities in a "*trusted*" foreign country. Such foreign requester *would not* be granted access to search the FinCEN database; rather, they would receive the specific beneficial ownership information requested.
- **Financial institutions** that seek beneficial ownership information in order to meet customer due diligence requirements under applicable law, *provided* that such reporting company consents to the search.
  - — Access limited to the applicable reporting company.
- **Treasury officers and employees** who require beneficial ownership information for their official duties or tax administration.

Access: Penalties and Safeguards

- Penalties:
  - Civil and Criminal Penalties for violating security and confidentiality requirements ($500 per day [$250k cap]; 5 years jail time)
  - Permeant debar or temporary suspension from accessing the database
- Safeguards
  - Secure, non-public database
  - Highest Federal Information Security Management Act level (FISMA High)

Specific Family Business Questions

- Ownership interests of a Reporting Company are gifted:
  - Assuming the transferee is deemed a Beneficial Owner, report such change within 30 calendar days.
- There is a change in fiduciaries of an entity or trust that owns a Reporting Company's interests (e.g., Trustee).
  - Report such changes within 30 calendar days.
- What about other powerholders that may not be fiduciaries (e.g., Business Advisors, Trust Protectors; Distribution Advisors; persons able to remove and replace a Trustee)
  - Depends on the structure of the applicable Reporting Company.

Next Steps: Best Practices

- Only form Reporting Companies when Governing Documents are final and ownership is confirmed.
- Obtain (and maintain) FinCEN identifier for those who may be Beneficial Owners and/or Company Applicants.
- Confirm who will be responsible for filing BOI with FinCEN – as well as who will be responsible for amending documents as necessary.
- Add CTA disclosure obligations to new governing documents
- Maintain database of information submitted on behalf of Reporting Company clients.

Next Steps: Things to Consider

- Will modifications be necessary for current <u>account documents</u> [
  - — Confirming who is responsible for filing.
  - — Who is responsible for updating information within the necessary timeframe]
  - — Who will review existing <u>corporate documents</u>? Any changes that need to be made prior to January 1, 2024 to avoid certain persons being reported (privacy concerns)?
- Who will be responsible for initial filings? Updated filings?
  - — Family Office?
  - — Manager?
  - — Individuals?
- How to notify clients of the new reporting requirement?
  - — Simply provide a statement, e.g., “In compliance with the [new reporting requirement] we are obligated to and will provide your information to the Reporting Company, so it can comply with its reporting obligations”?

CORPORATE TRANSPARENCY ACT

Questions?

Caitlin Kelly
Associate, Private Wealth
Katten

Daniel Cotter
Attorney and Counselor
Howard & Howard

Katten

Thank You!