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Terrorism Finance, Business Associations, and the “Incorporation Transparency Act”

*J. W. Verret**

I. INTRODUCTION

Each year, two million corporations and limited liability companies are established in the United States. The process by which these entities are created has traditionally been governed under state law. On June 18, 2009, the Senate Homeland Security Committee considered a bill introduced by Senators Levin, Grassley, and McCaskill, titled the “Incorporation Transparency and Law Enforcement Assistance Act” (the “Levin Bill” or “the Bill”). The Levin Bill requires that states maintain an accurate and updated list of all beneficial owners of corporations and limited liability companies created in the state and make that list available to law enforcement and others by subpoena.¹ In many states, these lists will likely become part of the states’ public records similar to other business entities’ formation documents.

Business entities, including corporations, limited liability companies (LLCs), limited liability partnerships (LLPs), non-profit organizations, and other entities created under hybrid forms, are created when formation documents are filed with the Secretary of State of a particular state. States require that business entities maintain updated contact information of an agent for service of process to facilitate litigation against a business entity, but, owing to the complexities of business ownership, states do not currently undertake the task of keeping an up-to-date list of all current owners of all business entities organized under their laws.

In support of the Levin Bill, its proponents cite a handful of cases investigated by federal agencies that were later dropped because of difficulty determining beneficial ownership in the investigated entities as evidence for why the bill is vital to stopping

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1. See S. 569, 111th Cong. (2009).

terrorism financing.² However, a proper analysis of the effects, costs, and potential constitutional challenges facing the Bill reveals it as little more than a red herring—an empty gesture meant to generate the appearance of action. Furthermore, although legitimate prosecution of business entities engaging in activities that represent a threat to national security or violate tax, banking, or securities laws is a vital element of the federal government's law enforcement mandate, this does not mean that state governments should be enlisted to support the Department of Justice (DOJ) merely because federal prosecutors find their work too difficult or expensive.

This Article will examine the costs of the Levin Bill and compare those costs with its purported benefits. As such, in part this Article offers an exercise in cost-benefit analysis. The analysis will remain somewhat stylized, without the need for formal modeling, simply because the legislative architecture under review offers scant benefit toward the goals listed in its opening clauses. This Article will show that the Levin Bill stands to impose significant liability on small businesses. The Article will describe how the Levin Bill threatens the existing function that business entities serve in economic development, as well as how it threatens to irreparably harm the attorney–client relationship. It will also describe how the Levin Bill offers little benefit, as it will be unable to prevent or reliably detect terrorism finance. Lastly, the Article will examine alternatives to the Bill that have been put forward.

The Levin Bill may not necessarily pass as it is currently crafted; however, the analysis in this Article is still highly relevant. The problems inherent in the Levin Bill's approach will creep into any variation on the Bill's theme of a federal mandate to track controlling beneficial owners of companies and other business entities. This Article's focus on the provisions in the current Bill will remain useful no matter what variation is considered. This is shown by the Article's final analysis of alternative measures put forward by the Senate Banking Committee and the Uniform Law Commission.

2. *Examining State Business Incorporation Practices: A Discussion of S. 569: the Incorporation Transparency and Law Enforcement Assistance Act: Hearing on S. 569 Before the S. Comm. on Homeland Sec. & Governmental Affairs*, 111th Cong. 7 (2009) [hereinafter *Hearing on S. 569*, Kaufmann Testimony] (statement of Adam S. Kaufmann, Assistant District Attorney for New York County, State of New York).

II. DETAILS OF THE LEVIN BILL

The Levin Bill mandates that states require corporations and limited liability companies to maintain with the state in which the business entity was formed an up-to-date list of all beneficial owners.³ A beneficial owner is defined as “an individual who has a level of control over, or entitlement to, the funds or assets . . . that, as a practical matter, enables the individual, directly or indirectly, to control, manage, or direct the corporation or limited liability company.”⁴ The Levin Bill also requires that the state maintain a copy of driver’s licenses of all such beneficial owners.⁵ The state is then required to turn information over to law enforcement or federal agencies requesting information through subpoena or pursuant on an international treaty.⁶ The Levin Bill carries stiff penalties for business entities failing to maintain an accurate list of their beneficial owners with the state.⁷ As a penalty for violation of the Bill, a business owner can be fined up to \$10,000 and sent to prison for up to three years for failure to maintain accurate beneficial ownership information with their state of formation.

The Levin Bill requires annual reporting that updates the states’ list of beneficial owners.⁸ The Bill also contains a provision that affords generous access to the beneficial ownership list, mandating that states make the list available upon “(i) a civil or criminal subpoena or summons from a State agency, Federal agency, or congressional committee or subcommittee requesting such information; or (ii) a written request made by a Federal agency on behalf of another country under an international treaty, agreement, or convention”⁹ Nevertheless, since most states would be required to keep beneficial ownership information open to the public, the wide restrictions would become fairly irrelevant, leaving the federal government with a nearly limitless ability to access the ownership information.¹⁰

The Levin Bill is the third beneficial ownership bill that the Senate has considered in the last ten years, and the second was one of the few bills endorsed by then-Senator Obama. The Levin Bill was the subject of hearings before the Senate Homeland Security Committee in July and November of 2009. The issue of beneficial

3. See S. 569.

4. *Id.* § 2009(e)(1).

5. See S. 569.

6. *Id.* § 2009(a)(1)(D).

7. *Id.* § 2009(b).

8. See S. 569.

9. *Id.* § 2009(a)(1)(D)(i)–(ii).

10. See Part V.A.

ownership reporting has recently become the subject of a turf battle between the Senate Homeland Security Committee and the Senate Banking Committee, where Chairman Dodd introduced a competing discussion draft.¹¹ A companion to the Levin Bill was introduced in the House of Representatives in 2009. With the support of the Department of Homeland Security (DHS), the DOJ, the Treasury Department, and numerous senators on both sides of the aisle, it seems likely that beneficial ownership reporting will become law in some form. With the Levin Bill currently serving as the chief vehicle for the debate, a particular focus on the Bill seems appropriate.

III. PROBLEMS WITH THE IMPLEMENTATION OF BENEFICIAL OWNERSHIP REPORTING

A. Internal Inconsistencies

At one level, the Levin Bill is internally inconsistent; even if one were to accept that beneficial ownership reporting will provide benefits sufficient to justify the costs to business entity creation, the Bill is designed in a manner that leaves loopholes that may lead to abuse of the nation's business entity creation system. For example, the Bill requires that the states collect and maintain beneficial ownership information on corporations and LLCs but not on LLPs, non-profit organizations, or other business entities.¹² As such, it is ineffective at hindering use of those entities for the crimes that the Levin Bill is intended to stop. Even if terrorists were to comply with the self-reporting requirements of the Bill, they could nevertheless merely switch to using these alternative business entity types for their illegal activities.

The National Association of Secretaries of State (NASS) also testified that non-profits would be nearly impossible to regulate under a beneficial ownership reporting regime, as they essentially do not have beneficial owners of any identifiable sort.¹³ In light of this fact, non-profits could become the new weapon of choice for money launderers under the present Bill. This could have the

11. The source is the author's own knowledge from working with the Committee.

12. See S. 569, § 2009(a)(1)(A).

13. *Examining State Business Incorporation Practices: A Discussion of S. 569: the Incorporation Transparency and Law Enforcement Assistance Act: Hearing on S. 569 Before the S. Comm. on Homeland Sec. & Governmental Affairs*, 111th Cong. 8 (2009) [hereinafter *Hearing on S. 569*, Marshall Testimony] (statement of Elaine F. Marshall, Secretary of State of North Carolina).

unintended consequence of tarnishing the reputation of the non-profit community. Indeed, evidence indicates that al-Qaeda operatives make significant use of non-profit charities in financing their operations, making their switch to non-profit entities—to the extent that they find use of entities necessary at all—more likely.¹⁴

The strongest critique of the Levin Bill is that it relies on individuals voluntarily reporting their beneficial ownership information. Indeed, the burden of the Levin Bill will fall most strongly on the companies least likely to break the law. In testimony before the Senate Oversight Committee, the U.S. Immigration and Customs Enforcement staff listed the types of investigations considered germane to the Bill, including money laundering, corruption, fraud, tax evasion, immigration and visa fraud, and financing terrorism.¹⁵ What is unique about those crimes is that they all include an element of fraud—perpetrators of the actual crime under investigation have to commit fraud as part of the crime. As such, those targets would also be the most likely to frustrate the purposes of the Bill by committing fraud in their reporting of beneficial ownership information to state secretaries of state.

Furthermore, states' compliance with the Levin Bill would effectively remove Homeland Security grant funding from other anti-terrorism efforts by local and state law enforcement and require states to use that funding for the new ownership reporting regime. If the states were to comply with the Bill, it would result in significant new costs to state governments without any additional appropriation to offset that cost. These costs include funding the hardware, software, and personnel required to collect, preserve, and make publicly available ownership information on thousands of business entities.¹⁶

One issue regarding the implementation of the Levin Bill involves what would happen in the event an LLC or corporation requested information from a beneficial owner and that beneficial owner was unwilling to provide the information. Could the LLC simply report that the owner was non-responsive but that the LLC made a good faith effort to comply? Would the Treasury

14. See THE 9/11 COMMISSION REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON TERRORIST ATTACKS ON THE UNITED STATES (2004).

15. See *Examining State Business Incorporation Practices: A Discussion of S. 569: the Incorporation Transparency and Law Enforcement Assistance Act: Hearing on S. 569 Before the S. Comm. on Homeland Sec. & Governmental Affairs*, 111th Cong. (2009) [hereinafter *Hearing on S. 569, Ayala Testimony*] (statement of Janice Ayala, Deputy Assistant Director, U.S. Immigration and Customs Enforcement, U.S. Dep't of Homeland Security).

16. See *Hearing on S. 569, Marshall Testimony, supra* note 13.

Department regulation instead require that the non-complying owner be prohibited from purchasing an interest in the business entity? If owners in existing business entities are covered by the Bill and their non-compliance resulted in the LLC owner being forced to sell his interest, it may implicate a Takings Clause challenge. Indeed, in the event that many of the eighteen million business entities in the United States found themselves unable to collect accurate beneficial ownership information, and were thus forced to nullify the investments of many of their owners, it could have a disastrous effect on small businesses and result in a torrent of alternative entity litigation.

On the other hand, though the Levin Bill does not currently provide this, the statute or implementing regulations could provide that entities already created would not be subject to the act, but merely new entities would be required to file. In that event, existing shell companies would be maintained, and a rush of new companies could be created just prior to implementation of the rule so that shell companies could be readily purchased, through which criminals could continue to avert the objectives of the Bill.

Straw transactors could also subvert the purposes of the Levin Bill's disclosure rule. A similar problem was faced by the Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF) in the regulation of gun sales, where handgun purchasers whose criminal history restricted their ability to purchase handguns got others to purchase the handguns for them. ATF has found that many illegal gun purchases take place through "straw men," or purchasers who do not show up when their names are run through registries of ineligible gun purchasers.¹⁷ One would expect that, if they were using business entities at all, terrorists or those planning to engage in money laundering would use straw men to form similar business entities. One prosecutor testifying in favor of the Levin Bill even surprisingly noted that participants in money laundering operations use straw men to open bank accounts.¹⁸ The United Nations report on terrorism indicated that individuals holding assets on behalf of those included on watch lists subvert anti-terrorism efforts,¹⁹ and this problem could be equally relevant to using beneficial

17. See *United States v. Nunez-Sanchez*, 478 F.3d 663, 664 (5th Cir. 2007).

18. *Hearing on S. 569*, Kaufmann Testimony, *supra* note 2.

19. U.N. Sec. Council, Sec. Council Comm. Established Pursuant to Resolution 1267 (1999) Concerning Afghanistan, *Second report of the group Monitoring Group Established Pursuant to Security Council Resolution 1363 (2001) and Extended by Resolution 1390 (2002)*, ¶ 37, U.N. Doc. S/2002/1050 (Sept. 20, 2002), available at <http://www.un.org/Docs/sc/committees/1267/1050E02.pdf> [hereinafter *Second Report of the S.C. Res. 1363 Monitoring Group*].

ownership information because the true beneficial owners could report the names of “straw men” on their formation documents.

Another complication could make the Levin Bill’s approach nearly impossible to administrate. The Bill requires that entities maintain a photocopy of a government issued ID of all beneficial owners with the state of incorporation, but individuals from all around the world form entities in states in the United States.²⁰ As a result, states could find themselves in the difficult position of trying to verify the validity of passports or local IDs from hundreds of foreign nations or potentially thousands of sub-regions of nations.

B. Difficulties in Determining Control

The Levin Bill defines beneficial owner as “an 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.”²¹ This definition links notions of ownership with notions of control, in effect treating them as though they are the same idea. As such, it implicates some very complex questions that arise in determining whether someone has control of a business entity.

There are two possible methods to implement a reporting regime to track possible illegal activity. One would be a focus on owners, the other a focus merely on those individuals or owners who actually control the company. The latter offers a clearer view of those who might be using the entity for illegal purposes, and yet, defining control, as this Section will show, is a particularly difficult task. A focus only on owners is much simpler to implement, but focusing on investors who may have no knowledge of the underlying business casts a wide net that requires reporting compliance by large numbers of individuals whose personal information will have no benefit to law enforcement. A similar argument has been raised with respect to a proposal to require reporting of beneficial owners of ships bringing cargo into U.S. ports.²²

20. See S. 569, 111th Cong. (2009).

21. *Id.* § 2009(e)(1).

22. See J. Bennet Fox, Jr., *Vessel Ownership and Terrorism: Requiring Disclosure of Beneficial Ownership is Not the Answer*, 4 LOY. MAR. L.J. 92, 100 (2005).

The Levin Bill implicates the definition of control in determining the beneficial owners who must comply when it states:

Each application to form a corporation or limited liability company under the laws of the State is required to provide to the State during the formation process a list of the beneficial owners of the corporation or limited liability company that—(i) identifies each beneficial owner by name and current address; and (ii) if any beneficial owner exercises control over the corporation or limited liability company through another legal entity, such as a corporation, partnership, or trust, identifies each such legal entity and each such beneficial owner who will use that entity to exercise control over the corporation or limited liability company.²³

The Bill's penalties are particularly harsh in light of the inherent difficulties in determining beneficial ownership of entities with a large number of owners, some of whom may be corporate entities themselves. Business entities often trade ownership in themselves and entities in which they invest in order to segregate specific investment risks and place them with the pool of investment capital most appropriate for that investment's risk profile and time horizon.²⁴ This process benefits large financial conglomerates, small businesses, union pension funds, university endowments, hedge funds, private equity funds, and state teachers' retirement funds alike.

The realities of business ownership, with its complex holding arrangements, make the costs of the Levin Bill prohibitive. Holdings are often structured with a network of ownership using flow-through entities. Powerful contractual rights are often held by non-shareholders.²⁵ This is done for legitimate tax efficiency planning purposes as well as to sell specific interests to groups of investors or to secure specific assets to interested creditors. For example, the ownership structure of the Carlyle Group, one of the largest private equity fund complexes in the world,²⁶ or of a typical grocery store franchise can share the quality of being held through complex business entities governed by even more complex credit

23. S. 569, § 2009(a)(1)(A).

24. Bernard S. Black & Ronald Gilson, *Venture Capital and the Structure of Capital Markets, Banks Versus Stock Markets*, 47 J. FIN. ECON. 243 (1998).

25. Laura Lin, *Shift of Fiduciary Duty Upon Insolvency: Proper Scope of Director's Duty to Creditors*, 46 VAND. L. REV. 1485 (1993).

26. See DAN BRIODY, *THE IRON TRIANGLE: INSIDE THE SECRET WORLD OF THE CARLYLE GROUP* (2003).

agreements. The Bill holds criminally liable any business failing to keep an accurate listing of its “beneficial owners” with the state in which it is registered, thus subjecting the two million businesses that form every year to unreasonable liability for a number of open questions concerning the real meaning of “beneficial owner” in today’s business environment.

With its passing reference to “control” as a trigger for beneficial ownership reporting, the Levin Bill fails to appreciate the complexities of determining shareholder control in business law. In some situations, holding a majority of shares can give a shareholder control over a business entity, but that is most certainly not a foregone conclusion. For instance, if the corporation has a staggered board, or one for which only a third of the directors go up for election each year, then holding a majority of shares will not actually give a shareholder control.²⁷ This is because a shareholder could not vote out a majority of the board with one election, but would have to wait for two successive elections to obtain control. By the same token, holding a small percentage of voting shares can give a shareholder control over a company in certain circumstances, as informed by the Treasury Department’s determination that for the purposes of its regulation of investment by foreign States in U.S. entities that hold national significance, a mere ten percent ownership is sufficient for an inference of control.²⁸

The application of many provisions of state corporate laws and federal securities laws frequently requires determinations of whether a shareholder has control of a company.²⁹ As such, decisions that determine what constitutes “control” under these laws provide a line of analysis that is likely to inform determinations of control for the purposes of applying the Levin Bill’s beneficial ownership reporting requirements.

One Delaware court determined that a forty percent shareholder was a controlling party on a realization that not all shareholders vote in elections.³⁰ The court noted that it must “take into account the fact that a 100% turn-out is unlikely even in a

27. Lucian A. Bebchuk, John C. Coates & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards*, 54 STAN. L. REV. 887 (2002).

28. See 31 C.F.R. § 800 (2008).

29. See, e.g., determinations of whether fiduciary duties apply to the controlling shareholder in *Cysive*, or determinations of whether a controlling shareholder faced joint and several liability with the issuer under the securities laws as required under Securities Exchange Act of 1934 § 20, 15 U.S.C. § 78t (2006).

30. *In re Cysive, Inc. S’holders Litig.*, 836 A.2d 531 (Del. Ch. 2003).

contested election. A 40% block is very potent in view of that reality."³¹ Another Delaware case from 1995 took judicial notice that the typical voting rate at that time would range between eighty and eighty-five percent:

The Court of Chancery and all parties agree that proxy contests do not generate 100% shareholder participation. The shareholder plaintiffs argue that 80–85% may be a usual turnout. Therefore, *without* the Repurchase Program, the director shareholders' absolute voting power of 23% would already constitute *actual voting power greater than 25%* in a proxy contest with normal shareholder participation below 100%.³²

The Delaware judges have noted the inconsistencies, stating, "We recognize that this makes the question 'what constitutes a change of control transaction?' important, and that much work remains to be done in helping the bar answer the question."³³ For example, in *Kahn v. Lynch*, the Delaware Supreme Court determined that forty-three percent stock ownership was sufficient to constitute control.³⁴ The court reasoned that with regard to the exercise of control, the:

[S]hareholder who owns less than 50% of a corporation's outstanding stocks does not, without more, become a controlling shareholder of that corporation, with a concomitant fiduciary status. For a dominating relationship to exist in the absence of controlling stock ownership, a plaintiff must allege domination by a minority shareholder through actual control of corporation conduct.³⁵

And yet, the Delaware general corporation law takes precisely the opposite approach, noting in Section 203 that

[a] person who is the owner of 20% or more of the outstanding voting stock of any corporation, partnership, unincorporated association or other entity shall be

31. *Id.* at 552 n.30 (citing *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1381 (Del. 1995)).

32. *Unitrin, Inc.*, 651 A.2d at 1381 (citing *Berlin v. Emerald Partners*, 552 A.2d 482 (Del. 1989)).

33. William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1321 n.130 (2001).

34. *Kahn v. Lynch Commc'ns Sys., Inc.*, 638 A.2d 1110 (Del. 1994).

35. *Id.* at 1114 (citing *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 70 (Del. 1989)).

presumed to have control of such entity, in the absence of proof by a preponderance of the evidence to the contrary.³⁶

Control is a basic concept that also runs through the securities laws. Some securities laws enhance the burden or liability facing controlling shareholders or persons, while others specifically prohibit actions that create certain control relationships.³⁷ In some areas, the securities laws take a direct approach and prescribe a certain percentage of ownership as constituting control, such as the presumption of the Investment Company Act of the 1940s that a twenty-five percent ownership position in a company constitutes control.³⁸ Section 13(d) of the Exchange Act, premised on creating an early warning system for other shareholders to warn them of an emerging controlling shareholder, requires a public filing of a shareholder's holdings upon any shareholder taking ownership in five percent of the voting securities of an issuer.³⁹ Section 16, which governs insider trading liability by controlling shareholders, takes effect by statute once a shareholder obtains a ten percent interest.⁴⁰

Indicia of control other than percentage ownership have been used in both securities law and other areas to define control. These include:

[P]ower to prevent significant action . . . because of ownership of stock; power to prevent the formation of a quorum for the transaction of business; sufficient number of shares to constitute a majority of those usually in attendance at a shareholders' meeting even if not a majority of shares outstanding; participation in the financing of the enterprise; close and intimate family relationships; ability to control if default occurred on preferred dividend payments; . . . and "historical and contractual associations."⁴¹

These factors are used contextually and typically result in determinations of control when a number of them are present together.⁴²

36. See DEL. CODE ANN. tit. 8, § 203(c)(4) (Supp. 2010).

37. A. A. Sommer, *Who's "In Control"?*—S.E.C., 21 BUS. LAW. 559, 559 (1966).

38. Investment Company Act of 1940 § 2(a)(9), 15 U.S.C. § 80a (2006).

39. Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m (2006).

40. Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78p (2006).

41. Sommer, *supra* note 37, at 575 (quoting *In re United Chems., Inc.*, 23 S.E.C. 456 (1946)).

42. *Id.* at 576.

Through Section 405 of the Exchange Act, the Securities Exchange Commission (SEC) has offered that “[t]he term control (including the terms controlling, controlled by and under common control with) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.”⁴³ While this is a broad definition, the SEC staff interprets it more broadly still. The standard practitioner’s advice is that a ten percent holding “should create caution” and might even “creat[e] a rebuttable presumption of control, especially if such holdings are combined with executive office, membership on the board, or wide dispersion of the remainder of the stock.”⁴⁴ The SEC recently noted the “widely held belief that the ownership of 20% . . . voting power in a widely held company in most instances constitutes control.”⁴⁵

A substantial line of authority supports the proposition that either the power to control or the actual exercise of control is sufficient, particularly in ways that do not involve the ownership of an equity interest at all. In *Walston & Co.*, the SEC held that the power to control, as evidenced by the creditor’s right to ninety percent of profits, its status as the source of most of Walston’s business, and its option to acquire stock, constituted control despite the fact that the creditor did not participate in the actual management of the business and held no actual stock.⁴⁶ In effect, the power to control is sufficient to make one a controlling person, despite the fact that the power is never actually exercised and the defendant did not actually own any stock. *S.E.C. v. Franklin Atlas Corp.*⁴⁷ also supports the notion that the percentage of stock ownership is not alone determinative. In that case, a manager with the ability to control an enterprise was determined to be a control person, even though he actually owned no stock, and the company had a controlling shareholder who owned a majority of the stock.⁴⁸

Another complication could arise where a shareholder owns shares in a company directly and also owns shares indirectly

43. See 17 C.F.R. § 230.405 (2008); see also 17 C.F.R. § 240.12b-2 (2009).

44. Raymond A. Enstam & Harry K. Kamen, *Control and the Institutional Investor*, 23 BUS. LAW. 289, 315 (1968) (the “rule of thumb” for the potential existence of working control is ten percent).

45. Order Approving Proposed Rule Changes Relating to the Shareholder Approval Policy, 54 Fed. Reg. 30,490, 30,492 n.23 (July 14, 1989).

46. Sommer, *supra* note 37, at 564 (citing *Walston & Co.*, 7 S.E.C. 937 (1940)).

47. *Id.* at 565 (citing *S.E.C. v. Franklin Atlas Corp.*, 154 F. Supp. 395 (S.D.N.Y. 1957)).

48. *Franklin Atlas Corp.*, 154 F. Supp. at 400.

through intermediary shell companies. Proponents of the Levin Bill or a similar beneficial ownership reporting approach might argue that one should simply consolidate ownership through intermediary holding companies using an assumption that a shareholder also owns any shares owned by an entity that the shareholder controls. Further, you could assume that a shareholder owns any shares controlled by an entity that is itself owned (or controlled) by an entity that the shareholder controls, and so on continuing through the chain of ownership consolidating shares in every new shell where the link of control remains. But the onus would be on the company, which stands at the end of that chain furthest removed from the individual shareholder, required by statute to report beneficial ownership to determine whether its shareholders or members owned interests through intermediary entities. Further, the reporting business entity would have to determine whether the shareholders controlled the other entities, which is, as we have seen, a very difficult question and one that would require the business entity reporting the information to depend upon the honesty, accuracy, and willingness to reply of shareholders or members who do not face the same liability for failure to report that the reporting business entity faces.

Two types of ownership common particularly in other countries, stock pyramids and cross holdings, could also significantly complicate the beneficial ownership reporting approach.⁴⁹ Ownership pyramids are frequently used to leverage control through multiple partly-owned intermediaries. In a pyramid, an investor might hold a twenty-five percent interest in an entity that holds a twenty-five percent interest in another entity, which itself holds a twenty-five percent interest in another entity, etc. Each entity along the pyramid is also owned by other investors, and the owner at the top of the pyramid maintains effective control over all of the companies in the pyramid despite having an ever decreasing actual interest in all of the companies along the pyramid.⁵⁰ A company reporting beneficial ownership would be placed in the difficult position of trying to determine whether the entities owning an interest in it were themselves controlled through a pyramid structure. As such, the cost in time and effort to comply with the beneficial ownership reporting

49. See Lucian Arye Bebchuk, Reinier Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash Flow Rights* 4–6 (Harvard Law School Olin Discussion Paper, Paper No. 249, 1999), available at <http://ssrn.com/abstract=147590>.

50. *Id.*

requirement could be tremendous, and that is assuming that the beneficial owners of the business entities accurately represented their identifying information to the reporting business entity.

Another difficulty lies where incidences of cross-holdings are considered, either simple cross-holdings or cross-holdings through a combination with pyramid holdings. Cross-holdings occur where entities hold ownership in each other.⁵¹ For some firms, this serves to reinforce their control. Company A will hold a large stake in Company B, and Company B can hold a large stake in Company A, and each could agree to implicitly support the other in votes put to the shareholders.

A variety of alternative methods using game theory or matrix theory have been considered as methods to consolidate shareholders into groups in order to estimate control in firms with cross-holdings or with pyramidal structures.⁵² But there is still a vigorous debate among these theories, and it would be inadvisable to compel small businesses to use game theory to determine their compliance. That is not the sort of inquiry that easily lends itself to a simple state compliance reporting form filled out by, for example, a small business owner.

If the beneficial ownership reporting approach takes a simple minimum ownership approach, such as a requirement that all owners with a three percent interest or greater are required to report their ownership, it would be a very easy system to subvert. For example, assume there are five companies, A–E, and each owns twenty-five percent of the other four. Now introduce a shareholder who has a negligible percentage of company A, say one percent. At that point, he has control of all five companies, despite the fact that he only owns one percent of the shares of one of the companies. That one shareholder actually can use the 1% interest in one company to control all of the shares that each individual company actually votes. If you were to appropriately consolidate that one shareholder's holdings you would see he effectively holds, through the holding companies by way of a combination of pyramid and cross-holdings, an effective 100% interest in all companies, but a simple count of each individual company's shareholders would not make his controlling interest apparent. As such, cross-holdings and pyramid holdings could be easily used to subvert any hard line minimum percentage used to define control.

51. *Id.*

52. See Marc Levy, *Control in Pyramidal Structures* (Centre Emile Bernheim Research Inst. in Mgmt. Scis., Working Paper No. 06/023, 2006), available at <http://www.solvay.edu/EN/Research/Bernheim/documents/wp06023.pdf>.

The final twist is that actual ownership of equity is completely unnecessary for control of a business entity. This is true for corporations, but it is even more accurate for LLCs, which leave open a wider space for creativity in designing ownership and interest structures. For instance, compliance with the Levin Bill might require a practical consideration of any special contractual powers that shareholders or the board of directors may possess. Shareholders may have special class voting rights or cumulative voting rights, the control benefits of which will depend on the situation and the way shareholders strategically use their special voting rights.⁵³ The board of directors may have a Section 203 requirement that the board approve purchases of more than twenty percent of the company's outstanding shares.⁵⁴ Company charters are also permitted to include supermajority voting requirements for some things, such as subsequent changes to the corporate charter.

Some of these factors increase the power of a particular percentage of stock held. Other contractual provisions may completely subvert shareholder control, and in other cases the effect may depend on additional factors. For instance, merely because no shareholder is able to purchase more than twenty percent of the stock without board approval does not necessarily mean that shareholders cannot exercise power against another shareholder with a large block of shares. Even if shareholders could not replace the entire board of directors in an election, as with a staggered board, the fact that shareholders must approve of mergers and certain other transactions—as well as the requirement that shareholders must approve of certain new issues of stock under listing rules of the Exchange Act—may maintain shareholder leverage. These factors may also substantially increase the power of a particular shareholder.

Options and other convertible securities also present a curious question for determining control. These represent the potential to control, but until they are exercised they do not represent actual control. Debt convertible into voting equity also presents further uncertainty for compliance with the Levin Bill. Another complication in administering this approach will be the difficulty of empty ownership and whether the presence of derivative positions that alter a shareholder's net equity position should be incorporated into the calculus.⁵⁵

53. DEL. CODE ANN. tit. 8, §§ 151, 203 (2006 & Supp. 2010).

54. *Id.* § 203 (Supp. 2010).

55. See Henry T. C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61 BUS. LAW. 1011 (2006). Though the problem of empty ownership is more relevant for

Proponents of a beneficial ownership reporting regime argue that the problems with defining control can be alleviated by wording the statute broadly to account for effective control rather than actual ownership, as is evidenced by the vague definition present in the current text of the Levin Bill.⁵⁶ But such broad wording, such as that in the current Levin Bill, would also subject an exponentially increasing number of individuals and entities to the ownership reporting requirements. As the Levin Bill is worded currently, a wide view of the beneficial ownership reporting requirement could mean that any shareholder, family member of a shareholder, individual with power of attorney over a shareholder, accountant regularly employed by the business, lien holder, bondholder of the company, credit card company or other financial entity extending credit to the business, and any other individual who may obtain a legal interest in the company would all be required to report their beneficial ownership or risk facing the criminal and civil sanctions that have been contemplated under the beneficial ownership reporting regime.⁵⁷

C. Difficulties in Determining “Beneficial Owner”

The firmest pushback against the Levin Bill has been regarding its definition of “beneficial owner” as being overly vague and overly comprehensive. This is, therefore, the section of the Bill most likely to be the subject of eventual compromise. However, even if the section omits its vague references to control and applies only to equity owners, it could still present numerous difficulties in execution.

Trading ownership shares of entities covered by the Bill could take place frequently, and the owners need not necessarily notify the filing entities of the change. Further, as beneficial ownership status changes hands involuntarily, including through settlement of an estate at death, seizure of securities put up as collateral to a creditor, or divorce proceedings, beneficial ownership status can remain uncertain for extended periods of time. Thus, as a result of the inherent uncertainty in determining beneficial ownership,

questions involving publicly traded securities, which are not covered by the Levin Bill, empty ownership is just as feasible for privately held entities.

56. See S. 569, 111th Cong. (2009).

57. See *Business Formation and Financial Crime: Finding a Legislative Solution: Hearing on S. 569 Before the S. Comm. on Homeland Sec. and Governmental Affairs*, 111th Cong. 5 (2009) [hereinafter *Hearing on S. 569, Kellogg Testimony*] (statement of David H. Kellogg, CEO, Solers, Inc.).

entities can become non-compliant with the reporting requirements of the Levin Bill despite their expensive efforts to the contrary.

The beneficial ownership approach could be easily contracted around through methods that are perfectly valid commercial practices. For instance, someone forming a business entity who did not want to report his ownership could form an entity, give ownership of that entity to another person, but assign that owner's rights to someone else. He could retain a secured interest in all of the entity's assets and, through a related debt instrument, require that the owner's failure to obtain his permission before disposing of any of the entity assets constitutes an event of default. And if the beneficial ownership reporting law was enforced such that individuals could be prosecuted for commercial transactions that gave creditors significant authority over the operating decisions of the owners of business entities, then the entire commercial credit industry could be put in jeopardy.

Another simple method to easily subvert the intent of the beneficial ownership reporting regime would be to set up a limited liability entity in what a recent Organization for Economic Co-operation and Development (OECD) report on beneficial ownership refers to as an offshore financial center.⁵⁸ That entity could itself serve as the beneficial owner of a U.S. entity. Since the offshore limited liability entity does not require beneficial ownership reporting information, the ultimate beneficial owner of the U.S. business would remain anonymous. Indeed, such an entity could also easily be formed in a number of other European countries that do not require beneficial ownership reporting, such as, among others, Ireland and Great Britain.⁵⁹ Further, trusts are not even formed through a state registry like other business entities.⁶⁰ Therefore, individuals could easily use trusts for illicit purposes or have trusts form business entities and maintain the trust as the beneficial owner of the formed entity.

58. See INVESTMENT DIV., ORG. FOR ECON. CO-OPERATION AND DEV., IDENTIFICATION OF ULTIMATE BENEFICIARY OWNERSHIP AND CONTROL OF A CROSS-BORDER INVESTOR 3 (2007), <http://www.oecd.org/dataoecd/57/8/41481081.pdf> [hereinafter IDENTIFICATION OF ULTIMATE BENEFICIARY OWNERSHIP AND CONTROL].

59. See FINANCIAL ACTION TASK FORCE, THIRD MUTUAL EVALUATION REPORT ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM: THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND § 1132, at 234, <http://www.fatf-gafi.org/dataoecd/55/29/39064399.pdf> [hereinafter FINANCIAL ACTION TASK FORCE, ANTI-MONEY LAUNDERING REPORT].

60. IDENTIFICATION OF ULTIMATE BENEFICIARY OWNERSHIP AND CONTROL, *supra* note 58, at 4.

The Treasury Department also urged that a simple concise definition of “beneficial owner” should be used, not the definition included in the Levin Bill.⁶¹ And yet, the more that the definition of “beneficial owner” is simplified to make it easier to administer, the more that those abusing the business entity formation system will be able to subvert the beneficial ownership reporting requirements of the Bill.

D. Attorney–Client Privilege

Attorneys typically begin the process of forming the corporations and LLCs covered by the Levin Bill as part of their representation of clients engaged in business transactions. Attorneys seek to help shield their clients from personal liability for the operation of their businesses and help their clients create entities that can afford greater access to capital through credit and equity injections.

The Levin Bill would expand the definition of “financial institutions” subject to the Patriot Act to include within that definition business entity formation agents as well as lawyers assisting their clients in forming business entities.⁶² This would subject lawyers to the full range of anti-money laundering surveillance requirements of the Patriot Act, which would devastate the confidentiality and privilege so key to the trust implicit in the attorney–client relationship.⁶³ Lawyers would have to file suspicious activity reports about their clients’ business transactions with the Treasury Department.⁶⁴ This would be an unthinkable requirement, for example, for tax lawyers representing their clients against the Treasury Department. It could severely limit the essential function of the privilege and confidentiality that preserves the incentive for clients to offer forthright disclosure to

61. See *Business Formation and Financial Crime: Finding a Legislative Solution: Hearing on S. 569 Before the S. Comm. on Homeland Sec. and Governmental Affairs*, 111th Cong. 9 (2009) [hereinafter *Hearing on S. 569*, Cohen Testimony] (statement of David S. Cohen, Assistant Secretary for Terrorist Financing, U.S. Dep’t of the Treasury).

62. See *Business Formation and Financial Crime: Finding a Legislative Solution: Hearing on S. 569 Before the S. Comm. on Homeland Sec. and Governmental Affairs*, 111th Cong. 3 (2009) [hereinafter *Hearing on S. 569*, Shepherd Testimony] (statement of Kevin L. Shepherd, Member, Task Force on Gatekeeper Regulation and the Profession, American Bar Ass’n); see also S. 569, 111th Cong. (2009).

63. See *Hearing on S. 569*, Shepherd Testimony, *supra* note 62.

64. Courtney J. Linn, *Redefining The Bank Secrecy Act: Currency Reporting and the Crime of Structuring*, 50 SANTA CLARA L. REV. 407, 513 (2010).

their lawyers in seeking legal advice that, in the long term, preserves the rule of law by guiding clients to follow the law.

Since 2003, with the passage of American Bar Association (ABA) Resolution 104, reiterated in 2008 with the passage of Resolution 300, the ABA has consistently voiced its opposition to government-mandated reporting provisions on lawyers based on the low “suspicion” threshold of the Patriot Act.⁶⁵ The Patriot Act’s application to the attorney–client relationship would also require that attorneys be precluded from notifying their clients that they filed a Suspicious Activity Report (SAR).⁶⁶ In order to protect themselves from liability, attorneys would feel pressure to file SARs on the slightest risk, thus creating a significant conflicts of interest with all of their clients.⁶⁷ This dynamic would be severely exacerbated by the Levin Bill. The Treasury Department also expressed opposition to the Levin Bill’s requirement that formation agents be subject to the Bank Secrecy Act and the Patriot Act.⁶⁸

The Financial Action Task Force (FATF) considered the difficult problem of appropriate attorney response to a suspicion of a client’s money laundering. It did not require attorneys assisting in business entity creation to collect and become responsible for beneficial ownership information. Instead it adopted an approach that advises attorneys to conduct due diligence on their clients only in the event that a number of risk factors are present, divided into country risk (whether the client is doing business with a country that is a known state sponsor of terrorism or terrorism haven), client risk (whether the lawyer has reason to believe that the client is engaged in risk activities and whether the lawyer has built a relationship of trust with the client over a long period of engagement), and service risk.⁶⁹

E. Altering the Competitiveness of Small Businesses, U.S. Businesses, and Privately Held Businesses

The costs of the Levin Bill will be fairly fixed and will apply only to companies that are not publicly traded.⁷⁰ As such, these costs can be expected to affect large businesses in different ways from small businesses, and they can also be expected to change the competitive position of publicly held companies versus privately

65. *Id.* at 10.

66. *Id.*

67. *Id.*

68. See *Hearing on S. 569*, Cohen Testimony, *supra* note 61, at 9.

69. See Nicole M. Healy et. al., *U.S. and International Anti-Money Laundering Developments*, 43 INT’L LAW. 795, 799–800 (2009).

70. See S. 569, 111th Cong. (2009).

held companies. With the requirement that states provide beneficial ownership information in response to inquiries from other nations, it will also stand to benefit State-owned businesses in foreign countries.

State-controlled foreign companies could abuse this process to enhance their competitive position against U.S. companies. Even assuming States are able to solve the problem of maintaining the privacy of beneficial ownership information, State-owned enterprises and foreign companies with strong relationships with their governments could encourage their governments to obtain private beneficial ownership information with the ostensible goal of law enforcement objectives, but with the real goal of obtaining information to enhance their competitive position against U.S.-owned companies.

Professor Bainbridge of UCLA Law School has also observed that the Levin Bill will harm the millions of small businesses exempt from SEC registration trading on the pink sheets.⁷¹ Though the Bill exempts entities registered with the SEC, Professor Bainbridge recognizes that when shareholders trade in an active market, an accurate list of their beneficial owners would be nearly impossible to maintain;⁷² therefore, the Bill ignores the fact that the same issue will be worse for smaller firms exempt from SEC registration.

Small businesses could face enormous compliance costs in trying to implement the beneficial ownership bill. The U.K.'s estimate for compliance costs for the average company is fairly extreme. A U.K. study estimates that compliance with an annual beneficial ownership regime would cost the average private company, at a minimum, nearly 25,000 pounds, or \$50,000, annually.⁷³ The Regulatory Impact Assessment (RIA) also admits that some companies may have to shut down as a result of the compliance costs that the new reporting requirement would involve.⁷⁴ A requirement to pay such high compliance costs could

71. The Incorporation Transparency and Law Enforcement Assistance Act, <http://www.professorbainbridge.com/professorbainbridge.com/2008/05/the-incorporation-transparency-and-law-enforcement-assistance-act.html> (May 3, 2008, 17:21 PST).

72. *Id.*

73. HM TREASURY & DEP'T OF TRADE AND INDUS., REGULATORY IMPACT ASSESSMENT ON DISCLOSURE OF BENEFICIAL OWNERSHIP OF UNLISTED COMPANIES 16 (2002), http://www.hm-treasury.gov.uk/d/beneficial_condoc.pdf [hereinafter HM TREASURY, REGULATORY IMPACT ASSESSMENT] (the full report that accompanies this summary document can be found at http://www.hm-treasury.gov.uk/consult_beneficial_index.htm).

74. *Id.* at 17.

have some fairly extreme consequences for the average small business.

One business owner testified that, because he uses employee stock ownership programs to pay his employees, he was concerned that the public nature of beneficial ownership reporting could result in competitors using publicly available beneficial ownership information on his business to recruit his employees.⁷⁵ Also, because he managed a private company, and publicly traded companies are likely to be exempt from the beneficial ownership reporting requirements, he felt it would put his company at a competitive disadvantage to the publicly traded firms.⁷⁶

Thus far this Article has focused on the costs of a new business entity beneficial ownership reporting regime. Cost-benefit analysis of new legislation and regulation tends to focus on only one side of the equation, depending on whether the author supports or opposes the new regulation or rule. The next Section of this paper will, however, undertake a full analysis of the benefits of the proposed regulation to determine how they compare against the costs that this analysis has thus far examined.

IV. LACK OF ABILITY TO STOP TERRORISM FINANCE

A. How the Levin Bill is Unrelated to Substantive Terrorism Finance

The principal purpose of the Levin Bill is to “ensure that persons who form corporations in the United States disclose the beneficial owners of those corporations . . . to assist law enforcement in detecting, preventing, and punishing terrorism, money laundering, and other misconduct . . .”⁷⁷ Terrorism finance must be divided into two distinct parts. First, it involves the flow of funds from the United States to destinations overseas where it makes its way into the hands of al-Qaeda or other terrorist organizations. Second, it involves the flow of funds from overseas locations to terrorist cells in the United States, where it can fund the activities of those cells for terrorist acts against the United States. In both cases, terrorists seek to hide the source, destination, and purpose of the flow of funds from government enforcement and intelligence agencies by using the underground banking system (Hawala), by using camouflaging transactions within the regulated banking system, or, in the case of terrorist cells, by

75. *Hearing on S. 569, Kellogg Testimony, supra* note 57, at 5.

76. *Id.*

77. *See* S. 569, 111th Cong. (2009) (preamble).

avoiding outside financing altogether and self-financing through criminal or legitimate employment.⁷⁸

The opening paragraph of the beneficial ownership reporting bills in the Senate articulates stopping terrorism finance as the overriding goal in requiring beneficial ownership reporting.⁷⁹ In part, this Article will consider whether business entities play a role in terrorism financing, and it ultimately concludes that they do not. Further, it will show that the objectives of the Levin Bill are already accomplished by existing regulations promulgated by the Treasury Department under the Patriot Act.⁸⁰ The members and witnesses at both of the Senate Homeland Security Committee's hearings on this issue seemed to almost ignore the issue of whether terrorist financiers would voluntarily self-report information on beneficial ownership disclosure forms. That issue remains a vital drawback to the bill, but this Section will set aside that threshold criticism for the moment to temporarily assume and explore how, even if criminals could be expected to accurately report their beneficial ownership onto forms filed with states of incorporation or formation, the Levin Bill would still be an ineffective tool in stopping terrorism finance.

In some ways, the notion that government regulation can stop terrorism finance through beneficial ownership reporting is inherently misguided. The Hawala banking system, the underground banking system that is most frequently mentioned in the context of terrorism finance, operates outside the conventions of the modern banking system and does not easily lend itself to regulatory solutions. In response to the Patriot Act and other banking regulatory initiatives, al-Qaeda affiliates have increasingly oriented their financing away from the Western world and into Southeast Asia.⁸¹ They have also turned almost exclusively to the Hawala system.⁸² Hawala banking is principally an issue for law enforcement in trying to track the flow of terrorism finance from developed nations to countries that are terrorist safe havens. The 9/11 Report revealed that, prior to 9/11, al-Qaeda was supported by

78. See JOST & SANH DU, *infra* note 88; see also THE 9/11 COMMISSION REPORT, *supra* note 14, at 170.

79. See S. 569 (preamble).

80. This Article takes no position on whether the costs of the Patriot Act's anti-money laundering provisions exceed their benefits. This is a much broader question than that analyzed in this Article, and many of the benefits of that particular provision will be evidenced by counterterrorism activities that may not make their way into the public record.

81. *Second Report of the S.C. Res. 1363 Monitoring Group*, *supra* note 19, at 3-4.

82. *Id.*

\$30 million in annual donations from charities and imams willing to divert funds to al-Qaeda.⁸³ It also relied on employees at charities who would siphon funds for al-Qaeda without the knowledge of their superiors.⁸⁴ Evidence suggests that al-Qaeda transferred money using the Hawala system.⁸⁵ In particular, it relied on Hawala networks in Dubai and Pakistan.⁸⁶ Hawaladars associated with al-Qaeda and charities that supplied money to al-Qaeda used bank accounts of regulated entities in transmitting funds from the Hawala system to their ultimate destinations.⁸⁷

Hawala banks are part of a payment system that originated in South Asia and operates outside the world of regulated banking.⁸⁸ Approximately \$200 billion is transferred annually around the world through the Hawala system.⁸⁹ Most Hawala transactions are used to process legitimate payments, but it is also a system plagued by money laundering. Owing to its popularity among fundamentalist Islamic terrorists, it is specifically a frequent conduit for terrorism finance. Hawala is in essence a swap system.⁹⁰ The typical Hawala dealer offers his services through a small grocery store or travel agency.⁹¹ Hawala banks are most frequently characterized by extensive networks of trust and family relationships.⁹² Transfers take place between a network of hawaladars.⁹³ Rather than registering asset transfers using negotiable instruments or central payment clearinghouses, hawaladars transfer money over the phone by word of mouth.⁹⁴ To transfer cash to another country, all one needs to do is contact a hawaladar in the United States and give them cash; that hawaladar will contact a colleague in the other country, and the local

83. THE 9/11 COMMISSION REPORT, *supra* note 14, at 170.

84. *Id.*

85. *Id.* at 171.

86. *Id.*

87. *Id.*

88. PATRICK M. JOST & HARJIT SINGH SANHDU, INTERPOL GENERAL SECRETARIAT, THE HAWADA ALTERNATIVE REMITTANCE SYSTEM AND ITS ROLE IN MONEY LAUNDERING (2000), <http://www.interpol.int/Public/FinancialCrime/MoneyLaundering/Hawala/default.asp>.

89. Maryam Razavy, *Hawala: An Underground Haven for Terrorists or Social Phenomenon*, 44 CRIM. L. & SOC. CHANGE 277, 288 (2005).

90. ROGER BALLARD, CENTRE FOR APPLIED SOUTH ASIAN STUDIES, PROCESSES OF CONSOLIDATION AND SETTLEMENT IN REMITTANCE DRIVEN HAWALA TRANSACTIONS BETWEEN THE UK AND SOUTH ASIA 2 (2004), <http://www.casas.org.uk/papers/pdfpapers/selectctte.pdf>.

91. *Id.* at 3.

92. *See* JOST & SANHDU, *supra* note 88.

93. *Id.*

94. *Id.*

hawaladar will give cash from his local safe to the intended recipient.⁹⁵ The same process works equally in the other direction.

Hawaladars can build relationships in a couple of ways. One hawaladar may owe the other money, in which case the remote payment is his way of repaying the colleague initiating the transaction (who will then keep the actual cash first delivered). They may be regular business partners or family members. If a balance remains in the account, one hawaladar can ship goods to the other and under- or over-invoice the shipment to balance the account. Given the ease of balancing accounts through exports and imports, many hawaladars also sell imported merchandise.⁹⁶

Hawala transmissions out of the U.S. are most likely to reach India or Pakistan, often by way of Dubai.⁹⁷ One of the most common regions serving as an intermediary in Hawala transactions is Dubai. There are many expatriate Indian and Pakistani workers living in Dubai, and financial transactions in Dubai are more lightly controlled than in India and Pakistan.⁹⁸ The industry is also divided into retail operators, who actually initiate transactions as agents of wholesale Hawala operators, who aggregate the transactions to help net them against each other before settlement with overseas counterparts.⁹⁹ These wholesale Hawalas typically make use of regulated banking accounts.¹⁰⁰ Dubai has also emerged as a central hub where brokers facilitate transactions between wholesale hawaladars, and Dubai also serves as a link between the West and destinations in Pakistan and India.¹⁰¹ One of the more frequent reasons cited for U.S. immigrants using the Hawala system to send money home are the restrictive foreign exchange controls promulgated by countries like India and Pakistan.¹⁰² There is only one node in the Hawala system in which business entities come into play, which is that in Dubai the central exchanges on which Hawala dealers conduct business are entities registered with the Dubai government.¹⁰³ These entities would, of course, not be covered by the U.S. regulations.

There is no evidence to suggest that hawaladars are forming U.S. business entities to facilitate their transactions. Most hawaladars operate through owner-operated businesses, which can

95. *Id.*

96. *See id.*

97. BALLARD, *supra* note 90, at 4.

98. *See* JOST & SANHDU, *supra* note 88.

99. BALLARD, *supra* note 90, at 4.

100. *Id.*

101. *Id.* at 5.

102. *Id.* at 7.

103. *Id.*

operate as sole proprietorships just as easily as incorporated entities.¹⁰⁴ The concurrent liability doctrine limits the usefulness of owner-operated shops.¹⁰⁵ Hawaladars also would not likely need to form business entities to protect themselves from liability to Hawala clients, as such grievances would typically be resolved through informal means for the same reason that the Hawala client chose to use an underground bank in the first place. Many of the clients of Hawala banks are illegal immigrants who, because they do not have a social security number, could not open a bank account.¹⁰⁶ Hawaladars also do not keep a paper trail of client transactions, something many clients find useful.¹⁰⁷ Hawaladars seek to keep their overhead low, which is part of the reason hawaladars are able to offer their clients more competitive exchange rates than most large national banks, and often operate with little more than a cell phone and a table in a tea shop.¹⁰⁸

Since the nature of Hawala transactions entails violation of customs and banking regulations, there is a greater risk that business entities that utilize the system would not accurately report beneficial ownership information. Even more importantly, hawaladars would have little reason to incorporate or use LLCs in their operations. Individuals whose sole income is derived from hawaladar services would obtain no benefit from entity formation. Small, unfranchised retail shops that are owner-operated would not obtain much benefit from incorporation either, as owners of such shops are likely to be required to cosign any loans they take out and face significant personal liability for their actions under the contemporaneous liability they would face as an individual tortfeasor. Further, there are already numerous sources of information available to law enforcement for small store operators, such as liquor licenses, gas distribution permits, business permits filed with local cities, and tobacco licenses filed with ATF. If those sources of information are falsified it would seem to indicate that LLC formation documents would be falsified as well.

One of the prime advantages of using business entities is liability shielding. The Hawala system operates through bonds of cultural and familial trust, and, as such, disputes are also resolved more informally as well.¹⁰⁹ Therefore, hawaladars would not benefit from liability protection in their operations. Furthermore,

104. See JOST & SANHDU, *supra* note 88.

105. See Karin Schwindt, Comment, *Limited Liability Companies: Issues in Member Liability*, 44 UCLA L. REV. 1541, 1548 (1997).

106. See JOST & SANHDU, *supra* note 88.

107. *Id.*

108. *Id.*

109. BALLARD, *supra* note 90, at 3.

their clients would not seek redress through courts because that would advertise their participation in unregulated banking activities. One punishment common in Hawala operations would be to exclude an operator who is found to have embezzled from clients or counterparties, and his entire family, from the Hawala system.¹¹⁰ According to the governing decrees of various imams, Islamic law governs the operation of hawaladars, and, where it conflicts with a nation's law, the decree of an Islamic Judge (a Hakim e sh'aran) governs.¹¹¹ Hawaladars will experience scant liability shield advantages from using business entities for their underground lending activity. To the extent that a member of the Muslim community has a grievance with his hawaladar, he is not likely to seek redress through the court system. First, Islamic law already offers him an avenue for redress.¹¹² Further, his choice of unregulated banking, governed as it is by cultural norms, may indicate a preference for resolving any conflicts with his hawaladar through the penalty mechanisms of those cultural and family norms. Finally, if the hawaladar's customers are using the Hawala system out of an interest in maintaining privacy from government regulators, either in the U.S. or in their home country, they also may have a clear preference against using the legal system for redress against the hawaladar. For these reasons, a hawaladar may have no interest in using a business entity to conduct his activities. One of the most powerful reasons to use an LLC or corporation to conduct business activities is to shield the owners of the business from personal liability for the tortious and contractual liabilities of the business entity,¹¹³ but if the relationship with the hawaladar can be expected to be governed by the decrees of an imam or through cultural mechanisms, then the limited liability aspect of business entities offer no benefit to the hawaladar.

If the hawaladar uses a bank account to store cash for his operation, the Patriot Act can, however, go a long way toward providing intelligence to determine whether a hawaladar is using it and, more importantly, whether he is engaged in terrorism financing. Some Muslim charities have also used legitimate charities as fronts for transfers to support terrorism. The Patriot Act can play a tremendous role in the interdiction of terrorism finance in this respect. The charities operate in the open, using

110. *Id.* at 12; see also Razavy, *supra* note 89, at 286.

111. Razavy, *supra* note 89, at 285.

112. *Id.*

113. Stephen M. Bainbridge, *Limited Liability Companies: A Primer on Value Creation through Choice of Form* (2000), available at <http://ssrn.com/abstract=250164>.

regulated financial entities. One would expect that donors who believe that the charity is operating legitimately might become suspicious if the charity asked for cash donations only. But the Levin Bill would not provide useful intelligence in this area if charity operators lied on ownership reporting forms provided by the incorporating state.

The critiques previously mentioned would apply to the flow of terrorism finance from the United States and other developed countries to countries that harbor terrorism. But additional challenges creep up when trying to use a government filing system to track the operational financing of terrorist activity as money flows from terrorist safe havens to countries vulnerable to attack. This is because that aspect of terrorism finance involves very small amounts. The 9/11 report estimated that the 9/11 hijackers spent between \$400,000 and \$500,000 to conduct their attacks.¹¹⁴ These funds came directly from Khaleid Sheikh Mohammed, the mastermind of the 9/11 attacks.¹¹⁵ There is no evidence to suggest that subsequent terrorist activity has involved larger sums of money. That amount of cash could be easily moved from terrorist safe havens to target nations. A million dollars in cash for instance, twice the amount used to finance the 9/11 terrorist attacks, weighs roughly twenty pounds and could be easily checked with luggage, carried on one's person, or shipped via Fed Ex (though the latter would involve the risk of detection by cash sniffing dogs).¹¹⁶ Other commodities, like diamonds or intellectual property, might weigh far less. With the simplicity of moving assets to target countries, it would make little sense for terrorists to use business entities set up in the United States to move money from terrorist safe havens to finance ground level operations. It would make little sense to use the regulated banking system. As such, targeting operational terrorist finance is left to the work of other disciplines, and a focus on using state corporate law and banking regulation for this issue is little more than an expensive distraction (though this Article will later argue that, between the two, existing banking regulation by way of the Patriot Act is far more effective than conscription of state corporate law).

The 9/11 Report's recommendations on terrorist financing are in favor of continued vigilance. They do not, however, include any reference to regulating or scrutinizing the use of business entities in terrorism financing. They also do not include any suggestion

114. THE 9/11 COMMISSION REPORT, *supra* note 14, at 169.

115. *Id.*

116. Federal Reserve Financial Services, Currency and Coin Frequently Asked Questions, http://www.frbervices.org/help/coin_and_currency.html#a7.

that beneficial ownership reporting would aid in the anti-terrorism effort. They also mention that:

[I]f al-Qaeda is replaced by smaller, decentralized terrorist groups, the premise behind the government's efforts—that terrorists need a financial support network—may become outdated. Moreover, some terrorist operations do not rely on outside sources of money and may be self-funding, either through legitimate employment or low-level criminal activity.¹¹⁷

This low level criminal activity includes petty theft, credit card fraud, and embezzlement.¹¹⁸

B. The Levin Bill Does Little that the Existing Banking Provisions of the Patriot Act Do Not Already Accomplish

Much of this Article has offered an analysis of why beneficial ownership reporting will not be effective in preventing terrorism finance. It is worth taking some time to show that alternative measures already in place provide far more useful tools to combat terrorism finance with more success, while at the same time minimizing the cost of compliance.

Prior to the enactment of the Patriot Act, anti-money laundering regulations consisted mostly of banks filing reports with the Financial Crimes Enforcement network if the transaction exceeded \$10,000; if it was part of a series of related transactions that seemed to have been structured to avoid the \$10,000 reporting requirement; or if it was a transaction over \$5,000 and was deemed suspicious.¹¹⁹ In the post-Patriot Act period, the money laundering rules focused on maintaining an audit trail for transactions that would not only allow investigators to link transactions to terrorist activity after the fact, but would actually stop the terrorist activity in the first place.¹²⁰ Anti-money laundering laws were originally designed to trace the proceeds of criminal activity, but in the wake of the 9/11 attacks, the focus of anti-money laundering laws shifted to the prevention of terrorist activity and the criminal acts that support it.¹²¹ And yet, the Levin Bill does not actually contemplate

117. THE 9/11 COMMISSION REPORT, *supra* note 14, at 383.

118. *Second Report of the S.C. Res. 1363 Monitoring Group*, *supra* note 19, at 11.

119. Eric J. Gouvin, *Are There Any Checks and Balances on the Government's Power to Check our Balances? The Fate of Financial Privacy in the War on Terrorism*, 14 TEMP. POL. & CIV. RTS. L. REV. 517, 525 (2005).

120. *See id.* at 527.

121. *Id.* at 517.

collecting large amounts of data and then mining through it for links to other databases. The Bill contemplates a structure where the federal government only obtains beneficial ownership information after the fact when it requests the information. As such, the Levin Bill is an odd creature to classify as part of the terrorism interdiction apparatus.

Anti-money laundering regulation originally was focused on stopping the proceeds of criminal activity, like drug distribution or tax fraud, from being camouflaged with multiple financial transactions.¹²² That has since given way to a different approach, focused instead on financial transactions used to support and hide terrorist activities.¹²³ Nevertheless, law enforcement has not hesitated to use rules promulgated out of terrorism concerns to assist them in both criminal and civil investigations of less importance than stopping terrorism.¹²⁴ Within the international community, anti-money laundering and terrorism finance rules are promulgated FATF.¹²⁵ The FATF convened on October 6, 2001, to begin developing guidance for member countries on implementing regulations designed to stop terrorism finance.¹²⁶

Most of the legislative language of the Patriot Act is dedicated to banking regulation designed to interdict suspicious financial activity linked to terrorism. Title III of the Patriot Act, titled the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001, includes key provisions that dramatically enhanced the government's tools in surveillance and prosecution of money laundering.¹²⁷ The Patriot Act focuses on the bankers who, as gatekeepers, have on occasion facilitated criminal money laundering and who are in the best position to detect suspicious activity.¹²⁸ As such, it does not rely on voluntary reporting by the

122. *Id.* at 538.

123. *Id.* at 517.

124. *Id.* at 535.

125. About the FATF, http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236836_1_1_1_1_1,00.html (last visited Mar. 21, 2010).

126. Gouvin, *supra* note 119, at 518.

127. See Courtney J. Linn, *Redefining the Bank Secrecy Act: Currency Reporting and the Crime of Structuring*, 50 SANTA CLARA L. REV. 407, 408 n.3 (2010) ("Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001, Pub. L. No. 107-56, tit. III, §§ 311-13, 319(b), 321, 326, 351-54, 358-59, 361-63, 365-66, 371-72, 115 Stat. 272. The PATRIOT Act amended the BSA to require financial institutions to establish anti-money laundering programs that included the development of internal policies, procedures, and controls; the designation of a compliance officer; an ongoing employee training program; and an independent audit function to test programs. 31 U.S.C. § 5318(h) (2006).").

128. *Id.*

same individual who might be engaged in underlying illegal activity supported by the money laundering, something which forms the core flaw in the beneficial ownership reporting approach of the Levin Bill. Even if bankers were knowingly colluding in criminal activity, something which we have not seen thus far in Patriot Act prosecutions, the internal audit system at a bank could serve as a backup check on collusion by an individual banker. In contrast, for the beneficial ownership reporting regime contemplated by the Levin Bill, only the individual owners and officers of the LLCs will be reporting. The result is that the Patriot Act will be highly effective in detecting terrorism finance where the banker is not knowingly colluding with the money launderer. But the Levin Bill, by contrast, contemplates a regime in which the self-reporting agent is the very same individual who is perpetrating the illegal activity.

One provision of the Patriot Act empowers the Treasury Secretary to require financial institutions to take steps to identify beneficial owners of bank accounts held by foreign persons.¹²⁹ Another provision permits the Treasury Secretary to issue regulations requiring that a bank identify customers whose transactions flow through accounts with a specific client financial institution or all client institutions in a specific country.¹³⁰ It also requires financial institutions in the United States to sever all banking relationships with foreign shell banks, defined as banks that have no physical presence anywhere.¹³¹ Banks must have in place anti-money laundering procedures that include internal policies, designation of a compliance officer, employee training, and an independent audit to test implementation of programs.¹³² It requires banks to respond to a request by a banking regulator for information regarding its anti-money laundering compliance program or a customer's records within 120 hours.¹³³ The Patriot Act also requires banks to have in place special due diligence for all foreign private customers and "enhanced" due diligence for senior political figures and their immediate families and for banks from jurisdictions deemed non-cooperative with FATF guidelines.¹³⁴ It also includes a requirement that banks implement reasonable procedures to identify all customers and consult a

129. Todd Stern, *The Money Laundering Abatement and Anti-Terrorist Financing Act Of 2001*, 119 *BANKING L.J.* 1, 2 (2002).

130. *Id.* at 2-3.

131. See Pub. L. No. 107-56, tit. III, §§ 311-13, 351, 352, 359 and rules promulgated thereunder.

132. Stern, *supra* note 129, at 2-3.

133. *Id.*

134. *Id.*

government provided list of known or suspected terrorists.¹³⁵ The definition of “financial institution” stretches widely to include banks, securities brokers and dealers, investment companies, insurance companies, travel agencies, car salesmen, and other institutions.¹³⁶ The Patriot Act mandates that banks verify the identity of individuals opening an account and maintain records of the information used to verify that identity.¹³⁷

Much of the structure of the Patriot Act pushes information upstream and requires banks to submit reports to the government. But one of the more powerful, and controversial, elements of the Patriot Act permits the reverse. The regulations implementing the Patriot Act further augment its power as an antiterrorism tool. For example, Section 314(a) permits federal agencies to collect transaction records that banks are required to maintain by the Patriot Act.¹³⁸ The procedural hurdles for the Financial Crimes Enforcement Network (FinCEN), part of the Treasury Department, in assisting law enforcement agencies to collect this information are fairly easy to overcome and do not require a warrant or subpoena.¹³⁹ Instead, the regulation merely requires that FinCen provide a certification that the subject of the investigation is reasonably suspected to be engaging in terrorist money laundering activity.¹⁴⁰

The Patriot Act’s approach enlists compliance reporting assistance at the hubs of the economy, within banks where most of the financial institutions are already subject to regulation and that specialize in transactions with large groups of customers. The Levin Bill, by contrast, takes a spokes approach, focusing on individual business owners who may engage in very few transactions. Thus, rather than collecting high quality information, it seeks to amass a high volume of information. In terms of compliance cost, the Patriot Act also permits economies of scale. As central hubs in the economy, banks are in a better position to specialize in compliance. Rather than complying once a year, they comply with the Patriot Act’s provisions every day and can dedicate departments to compliance activity. They are also in a better position to detect suspicious financial transactions and are, in effect, deputized by the Patriot Act as part of a national financial intelligence network. The owners of individual LLCs set up to

135. *Id.*

136. 31 U.S.C. § 5312 (2006).

137. Gouvin, *supra* note 119, at 529.

138. *Id.*

139. *Id.*

140. *Id.* at 531.

invest in real estate, run local shops and trade offices, or acquire technology companies do not possess that expertise. And, indeed, the only beneficial owners of LLCs that matter are those engaged in criminal activity. This argument may also hold true for the other financial actors newly included within the definition of “financial institution” under the Levin Bill.

The other overwhelming difference between the Patriot Act’s approach and the Levin Bill’s approach is that while the Patriot Act arguably raises privacy concerns because of information sharing with the government, it does not involve information sharing in the public domain. The Levin Bill’s approach, by contrast, would necessitate sharing beneficial ownership information with the public. Thus, claims made during hearings on the Levin Bill that the states would have the option of whether or not to make beneficial ownership information public are misleading. Most states would actually be required to amend their right to know laws, and in many instances actually amend their constitutions, in order to maintain the confidentiality of beneficial ownership information.

One benefit to the Patriot Act’s approach is that it narrowly tailors the burden of compliance to two situations where the benefits of financial intelligence are likely to exceed the costs. The first is where an objective intermediary, who also faces the prospect of liability for violations of recordkeeping provisions of the Patriot Act, sees something that raises suspicion. The second is a class of transactions with certain banks or countries that are at higher risk of participation in terrorism. The Levin Bill, on the other hand, does not tailor compliance at all. As such, the total cost of compliance is more likely to exceed the benefits of the Bill. Further, it is more likely that the information overload that results will present its own distinct problems. To state the problem more colloquially, the Patriot Act’s approach is like looking for a needle in a haystack by giving metal detectors to farmers, a difficult approach to be sure. But the Levin Bill’s approach looks for the same needle by asking farmers to file pictures of their haystacks with the government.

C. An Alternative Explanation for Law Enforcement’s Interest

Law enforcement has not hesitated to use rules promulgated out of terrorism concerns to assist them in both criminal and civil investigations of less importance than stopping terrorism.¹⁴¹ Indeed, Section 314(a) of the Patriot Act is so powerful that some

141. *Id.* at 535.

have suggested that federal authorities will be unable to resist abusing it to assist in all law enforcement activities that would justify the attendant risk to financial privacy, not merely those linked to terrorism.¹⁴² In “Operation G-Sting,” the federal government used Patriot Act powers to build a case against elected officials caught up in a bribery scandal involving regulation of adult strip clubs.¹⁴³ Publicly available information did not include any allegation that the targets were engaged in terrorist money laundering, and, since there is no meaningful check on FinCEN’s certification of suspicion of terrorist activity, the federal government is likely to continue to use it as such. The same risks would apply with beneficial ownership reporting, particularly under the language of the Levin Bill as a previous Section of this Article explored.

Another issue with the Levin Bill is the leverage it will afford prosecutors in negotiating settlements with companies. There is already substantial literature suggesting that prosecutors have too much leverage over corporate defendants.¹⁴⁴ Piling on regulatory infractions can give the government tools to prosecute businesses even when the businesses are able to secure not guilty verdicts on the underlying offenses that the government is prosecuting.¹⁴⁵ Given the analysis in previous Sections about the difficulty in determining control and ownership for purposes of compliance with the Levin Bill, prosecutors may be able to seek indictment for violation of the Levin Bill in parallel with other indictments. The same has been true for money laundering prosecutions since the advent of money laundering regulations, where the underlying crimes are fairly insignificant but defendants receive large sentences for financial transactions that by themselves are innocuous.¹⁴⁶

142. Gouvin, *supra* note 119, at 534–35

143. *Id.*

144. See Jeffrey Parker, *Rules Without . . . : Some Critical Reflections on the Federal Corporate Sentencing Guidelines*, 71 WASH. U. L.Q. 397 (1993).

145. Money laundering is, in effect, a derivative crime, characterized by what would otherwise be perfectly legal activity that becomes illegal because it relates to other underlying, *malum in se* offenses. See HM TREASURY, SUMMARY, *infra* note 214, at 5.

146. See, e.g., *United States v. McNab*, 331 F.3d 1228 (11th Cir. 2003).

V. DRAWBACKS TO THE LEVIN BILL

A. Business Privacy

The Levin Bill purportedly allows states to decide whether to keep the beneficial ownership information private or make it publicly available. Many states could require additional resources to ensure privacy of ownership information, and some could require amendment to their state constitutions to keep filed ownership information private.¹⁴⁷ In fact, under the right to know laws of thirty-eight states, those states would not be permitted to keep beneficial ownership information of businesses private. Under public records laws of a majority of states in the U.S., which are quite broad in their application, beneficial ownership filings of the type envisioned by the Levin Bill would be deemed public records that the state secretaries of state would not be permitted to keep confidential.¹⁴⁸

Costs to business privacy would be significant. Legitimate businesses have important interests in maintaining the privacy of the ownership structures that they use to invest in new projects. This not only impacts purchase prices for target companies, but also purchase prices for target assets, particularly real estate. High profile real estate developers may be unable to accumulate and assemble significant parcels of land needed for major development projects in an environment where their control of these entities is a matter of public record. Prices would be bid up based solely on the identity of the beneficial owner of the acquiring entity, and some economic development of local communities could ultimately not occur that otherwise may have been built. In some sense we can consider the Levin Bill as a redistribution mechanism that decreases the bargaining leverage of business entities and increases the bargaining leverage of individuals not negotiating through business entities in the market for a wide variety of assets.

With trillions of dollars of economic activity tied up in the eighteen million presently existing U.S. business entities, the temptation and pressure to infiltrate this information will be enormous. This will introduce costs to ownership privacy even if

147. See *Examining State Business Incorporation Practices: A Discussion of the Incorporation Transparency and Law Enforcement Assistance Act: Hearing on S. 569 Before the S. Comm. on Homeland Sec. & Governmental Affairs*, 111th Cong. 7 (2009) [hereinafter *Hearing on S. 569*, Haynsworth Testimony] (statement of Harry J. Haynsworth, Chair, Drafting Commission on Uniform Law Enforcement Access to Entity Information Act).

148. See generally 76 C.J.S. *Records* § 113 (2009); see also 37A AM. JUR. 2D *Freedom of Information Acts* § 56 (2010).

states are able to amend their constitutions to counter the application of the open records requirement to beneficial ownership reporting. Ultimately, if venture investors can no longer keep their early stage investment activities confidential, they lose the incentive to park their capital in such firms. For example, the next Pixar may find it impossible to develop its product under the spotlight of public knowledge that someone like Steve Jobs is a principal investor.¹⁴⁹

Law enforcement personnel assert that the use of corporate shell companies hampers their ability to investigate corporate suspects. This argument is limited by the lack of a generally accepted definition of a “shell company.” There are both legitimate and illegitimate reasons to use corporate forms that have few assets in corporate mergers, acquisitions, joint ventures, and other legitimate business activities, and proponents of the Levin Bill over-generalize in their suspicion of all shell companies. For instance, shell companies are often used as the acquisition vehicles whereby one company will purchase an interest in another company.¹⁵⁰ One reason incorporators may seek to keep beneficial ownership information private is that the identity of the buyer of a target company in an acquisition may alter the price charged. Making public the identity of the owner could also threaten vital intellectual property or trade secrets for participants’ joint ventures.

Maintaining privacy for beneficial ownership information may also be vital to executive recruitment. Where equity stock grants in business entities are used as a form of compensation, publicizing beneficial ownership information may harm an executive’s financial privacy. It may also be that investors in politically sensitive projects would want to minimize reactionary public response to their investments, as where college endowments invest in forestry projects that some interest groups oppose or a state pension fund invests in companies overseas.

Some individuals may also use business entities to maintain their privacy in interactions with banks or the government, while fulfilling their obligations as taxpayers, without nefarious purpose. Every year stories surface about government employees who use their access to financial data for non-work purposes, such as

149. Michael Hirschorn, *Success Story 2*, N.Y. TIMES, Jun. 22, 2008.

150. Tim Castelli, *Not Guilty By Association: Why the Taint of their Blank Check Predecessors Should Not Stunt the Growth of Modern Special Purpose Acquisition Companies*, 50 B.C. L. REV. 237 (2009).

looking up incomes of famous actors or their neighbors.¹⁵¹ Individuals may also have an interest in keeping their personal financial information private from employees of their local bank or savings and loan. Business entities can give taxpayers and bank customers an opportunity to protect their financial privacy while fulfilling their obligations to the government or the banks that serve their financial needs.

A beneficial ownership reporting requirement could also threaten the anonymity of philanthropic donors. If a donor gave, as many do, their interest in a business entity as part of a bequest to some public university or other recipient, it may become impossible to honor a donor's wish for anonymity, as the change in beneficial ownership from the donor to the public institution would show up in publicly available beneficial ownership information.

Information about ownership of business entities can also indirectly reveal the substance of financial transactions that a firm may have competitive reasons for keeping private from competitors, suppliers, employees, creditors, and customers.¹⁵² As such, revealing the ownership information through the public domain could alter the negotiating leverage of business entities with their transaction partners in unintended ways.

B. The Purpose of Alternative Entities Is Frustrated by the Bill

One of the major drawbacks to the Levin Bill is that it would limit the freedom of contract approach implicit in many states, particularly Delaware's approach to LLC and alternative entity law.¹⁵³ Delaware has designed its LLC legal regime to facilitate freedom of contract to allow parties to LLC agreements to arrange their relations according to their particular needs.¹⁵⁴ One of the reasons that the LLC entity was created in the first place was to permit owners of alternative entities (non-corporate entities) to participate in the management of an enterprise while still

151. See, e.g., Andrea Coombes, *IRS employee sentenced for snooping*, MARKETWATCH, Aug. 20, 2008, <http://www.marketwatch.com/story/irs-worker-snooped-on-tax-records-of-almost-200-celebrities>.

152. See G. Scott Dowling, *Fatal Broadside: The Demise of Caribbean Offshore Financial Confidentiality Post USA Patriot Act*, 17 TRANSNAT'L LAW 259, 268 (2004).

153. Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221-42 (2009).

154. See, e.g., DEL. CODE ANN. tit. 6, § 18-1101(b) (2006 & Supp. 2009) ("It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.").

maintaining limited liability, a feature that was not available for LLPs.¹⁵⁵

LLCs also offer an advantage over corporations in that they do not mandate particular ownership structures or treatment of distinct classes of owners in the way that corporations do.¹⁵⁶ Many LLCs also permit free assignment of ownership rights and facilitate a divergence between ownership and assignment of financial rights.¹⁵⁷ LLC laws also do not mandate a single control method, unlike corporation statutes, which require annual elections for a board of directors to manage the company.¹⁵⁸ As such, they permit a level of creativity in structuring the rights and duties of LLC members to each other in the management of the enterprise. A beneficial ownership reporting requirement could threaten all of these innovative benefits of the LLC form. As relations are structured to evade the control element of the beneficial owner definition, while at the same time operating under the cloud of uncertainty that the definition leaves open, LLC members will be restricted in taking advantage of the full benefits that the LLC form has to offer.

One factor that would complicate determinations of control in LLCs is that, by default, an LLC is managed by its members rather than by, as in the corporate form, a board of directors.¹⁵⁹ This could lead to all members of LLCs being considered, by default, in control of the LLC for the purpose of applying a control test for ownership reporting. In the event that an LLC contract opted out of the default rule, uncertainty would prevail over whether the default was sufficient to eviscerate control. Complicating this question even further is the fact that states differ on how much control members retain by default, so even if the Treasury Department were to try and anticipate by administrative guidance, it would have to consider how the myriad of possible contractual provisions allocating control would change the beneficial ownership definition under fifty separate LLC statutes.¹⁶⁰

To present a fair picture of how the Levin Bill affects LLC law, it should be noted that one policy issue that complicates LLC law would be limited by the beneficial ownership reporting requirement. Professor Larry Ribstein notes that differences in

155. See Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 385 (1992).

156. *Id.*

157. *Id.* at 389.

158. DEL. CODE ANN. tit. 8, § 211 (Supp. 2010).

159. See RIBSTEIN, UNINCORPORATED BUSINESS ENTITIES 364 (2d ed. 2000) [hereinafter RIBSTEIN, UNINCORPORATED BUSINESS ENTITIES].

160. *Id.* at 365.

state statutes regarding the authority of LLC members to bind the LLC make it difficult for third parties to reliably predict whether an LLC member has such authority.¹⁶¹ He also notes that, even if a statute controls whether a member or a manager has the authority to bind a firm, and to what degree, there is no requirement that LLCs disclose their beneficial owners publicly.¹⁶² The Levin Bill would minimize this issue. And yet, there are far simpler ways to address the problem of whether LLC members or managers can bind the LLC, and to what extent.¹⁶³

The Levin Bill would also complicate the operation of voting trusts, which are agreements whereby members reallocate power temporarily by granting the right to vote their interests to a trustee.¹⁶⁴ Trustees may be cautious about undertaking the voting responsibility out of concerns about beneficial ownership reporting compliance.

In the event that states have to include reporting of beneficial ownership as a prerequisite to LLC formation, the uncertainty implicit in the beneficial ownership definition assumes particular import. If the formalities of business formation are not met, which could include proper reporting of beneficial owners, the business entity is disallowed and treated like a general partnership with its attendant personal liability for the business' liabilities.¹⁶⁵

The series LLC is an innovation of the Delaware LLC statute that permits relief from veil-piercing liability by allowing LLCs to designate a series of members, managers, or LLC interests with separate rights, powers, or duties with respect to specified property or obligations or profits associated with that property.¹⁶⁶ This business form, the most recent innovation at the forefront of alternative entity evolution, would seem nearly impossible to fit within a beneficial ownership reporting framework.¹⁶⁷ The issues with determining beneficial ownership and control compliance could become nearly impossible as series LLC interests become increasingly complex. Indeed, the Levin Bill could kill the series LLC altogether.

161. *Id.* at 365–66.

162. *Id.* at 366.

163. *Id.* For instance, Professor Ribstein notes that clear drafting in the LLC agreement, combined with a requirement to file that agreement, may remedy much of the problem.

164. *Id.* at 368.

165. *See id.* at 344.

166. Christopher McLoon & Margaret Callaghan, *The Dangerous Charm of the Series LLC*, 24 ME. B.J. 226, 229 (2009)

167. *See RIBSTEIN, UNINCORPORATED BUSINESS ENTITIES*, *supra* note 159, at 346.

A member's status as a manager in an LLC, and his attendant control over the entity's affairs, can affect his fiduciary duty liability to the other members of the LLC (assuming the entity has not contracted around it or the state of formation does not permit contractual opt-out).¹⁶⁸ As such, if the beneficial ownership requirements were triggered upon achieving control, then a firm's decision to file certain beneficial ownership information could be taken as evidence that the member whose information was filed was in control of the entity; thus, such reporting could leave that member with significant risk of liability.

States also differ on the types of events, including bankruptcy and death, that institute disassociation of the LLC and could possibly result in immediate dissolution of the LLC.¹⁶⁹ If the Treasury's definition of "LLC dissolution" and the state's definition are different, it could also result in problems with the obligation to report beneficial ownership.

The Levin Bill could also make it difficult for non-profit entities to own an interest in LLCs, as non-profits do not have an identifiable owner. Non-profits often own an interest in LLCs to facilitate their mission, as, for instance, where non-profit hospitals partner with for-profit medical services companies to jointly provide medical services.¹⁷⁰ But if the LLC is unable to identify its non-profit owner, owing to the fact that beneficial ownership is not a term that fits properly within the non-profit organization context, it may make it difficult for the LLC to give an equity interest to a non-profit organization. This could also hold true for LLCs given as donations to charitable or non-profit institutions. If, for instance, an oil mogul donated an LLC owning his royalty rights to a university, and it made sense for transactional planning purposes to make the university a member of the LLC, it could be difficult for the LLC to comply with the beneficial ownership reporting rule because the university has no beneficial owner.

The Levin Bill also poses serious risks to the ongoing evolution of alternative business entities. One such issue is the use of LLCs for non-profit purposes. For example, LLCs have been used to accomplish, through contractual means, the objectives of marriage, such that same sex-couples have pooled their assets by way of forming LLCs together.¹⁷¹ Those couples may have a privacy objection to having their association made a part of public record.

168. *Id.* at 372.

169. *Id.* at 373–74.

170. See 2 RIBSTEIN & KEATINGE ON LLCs § 22.3, at 22–28 (2d ed. 2008).

171. See RIBSTEIN, UNINCORPORATED BUSINESS ENTITIES, *supra* note 159, at 404.

C. Constitutionality Challenges

The Levin Bill directly implicates the allocation of power between the states and the federal government. As such, constitutional challenge to the Bill can be expected depending on the types of provisions that eventually make their way into the Bill.

In *Whalen v. Roe*, the United States Supreme Court heard a challenge to a New York state law requiring physicians to file copies of controlled substance prescriptions with the state, which were then kept with the state health department.¹⁷² Public disclosure of the patient's identity was prohibited, and access to the files was confined to a limited number of Health Department personnel.¹⁷³ A challenge was instituted based on the defendant's right to privacy in his prescription information.¹⁷⁴

The Court took note of the fact that there were no other available avenues for the Health Department to prevent unlawful prescription of narcotics.¹⁷⁵ The Court also noted that extensive steps were taken to ensure that patients' information was not revealed to the public, including locked fences and special security measures.¹⁷⁶ While recognizing the importance of privacy concerns, the Court found that there was no reason to suggest that the state's security measures would result in public dissemination of private patient information.¹⁷⁷ In contrast, the Levin Bill would result in precisely the opposite result; it would result in the wide dissemination of private ownership information.

Another relevant constitutional issue that may arise could involve the Fifth Amendment rights of LLC owners. Though the entities themselves will not enjoy Fifth Amendment protection against self-incrimination,¹⁷⁸ the owners of the entities subject to

172. 429 U.S. 589, 589 (1977).

173. *Id.*

174. *Id.*

175. *Id.* at 592. The Chairman of the T.S.C. summarized its findings:

Law enforcement officials in both California and Illinois have been consulted in considerable depth about the use of multiple prescriptions, since they have been using them for a considerable period of time. They indicate to us that they are not only a useful adjunct to the proper identification of culpable professional and unscrupulous drug abusers, but that they also give a reliable statistical indication of the pattern of drug flow throughout their states: information sorely needed in this state to stem the tide of diversion of lawfully manufactured controlled substances.

Id. n.6.

176. *Id.* at 594.

177. *Id.* at 601-02.

178. *Bellis v. United States*, 417 U.S. 85 (1974).

the act may be forced to reveal ownership information that could be used against them in a criminal prosecution. A statute requiring the maintenance of beneficial ownership information could operate in conjunction with the “required records doctrine” to eliminate Fifth Amendment protection for personal ownership information.¹⁷⁹

Yet another constitutional issue implicated by the Levin Bill involves state sovereignty. In *Printz v. U.S.*, the Supreme Court invalidated provisions of the Brady Bill that imposed mandatory regulatory requirements on local law enforcement.¹⁸⁰ The Brady Bill required chief law enforcement officers, to whom a transferor of a handgun provided notice of transfer, to make reasonable efforts to ascertain within five business days whether receipt or possession would be in violation of the law; such reasonable efforts required research in whatever state and local record-keeping systems were available and research in a national system designated by the United States Attorney General.¹⁸¹ The Court noted that the Brady Bill did not require the state law enforcement officers to prevent illegal sales.¹⁸² While the opinion recognized that the federal government has the right to condition federal expenditures on a state’s implementation of certain regulations,¹⁸³ in this case the Levin Bill does not so condition federal expenditures. While the Levin Bill mentions that states can use already appropriated homeland security funding to implement this mandate, it does not condition the expenditure on that funding.

The Court in *Printz* did note a duty on the part of states and their officials to the federal government to enact, enforce, and interpret state law in such fashion so as not to obstruct the operation of federal law; all state actions constituting such obstruction, even legislative acts, are invalid.¹⁸⁴ However, with the Levin Bill, state officials are not interpreting state law in such a way as to negate federal law; the only way they could do so would be to fail to follow the affirmative requirement to act in much the same way that local sheriffs in *Printz* were negating the operation of state law by failing to follow the requirements of the invalidated Brady Bill. The Brady Bill in *Printz* included a penalty of up to a

179. See *Grosso v. United States*, 390 U.S. 62, 67–68 (1968) (describing the components of the required records doctrine established in *Shapiro v. United States*, 335 U.S. 1 (1948)).

180. 521 U.S. 898 (1997).

181. *Id.* at 902 (citing 18 U.S.C.A. § 922 (1993)).

182. *Printz*, 521 U.S. at 904.

183. *Id.* at 960–61.

184. *Id.* at 913 (citing *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238 (1984)) (federal preemption of conflicting state law).

year in prison for anyone failing to comply with the law, which would presumably have applied to law enforcement officers covered by the Brady Bill.¹⁸⁵ Justice Scalia articulated the Court's interpretation of state sovereignty succinctly: "The Federal Government may not compel the States to enact or administer a federal regulatory program."¹⁸⁶ *Printz* is often cited, but it was not the first time that the Supreme Court determined that federal compulsion of state regulation through affirmative requirements is unconstitutional.¹⁸⁷

In part, the Court's reasoning was articulated through an understanding of the Framers' experience with the failure of the Articles of Confederation, which was due principally to the fact that they contemplated exercise of federal power through the states.¹⁸⁸ The Court also firmly rested on the principle that the

185. Paul Finkelman, *The Roots of Printz*, 69 BROOK. L. REV. 1399 (2004).

186. *Printz*, 521 U.S. at 926.

187. Justice Scalia explained further:

In *Hodel v. Virginia Surface Mining & Reclamation Association, Inc.* and *FERC v. Mississippi*, we sustained statutes against constitutional challenge only after assuring ourselves that they did not require the states to enforce federal law. In *Hodel* we cited the lower court cases in *EPA v. Brown*, but concluded that the Surface Mining Control and Reclamation Act of 1977 did not present the problem they raised because it merely made compliance with federal standards a precondition to continued state regulation in an otherwise preempted field. In *FERC*, we construed the most troubling provisions of the Public Utility Regulatory Policies Act of 1978 to contain only the "command" that state agencies "consider" federal standards, and again only as a precondition to continued state regulation of an otherwise preempted field. We warned that "this Court never has sanctioned explicitly a federal command to the States to promulgate and enforce laws and regulations."

Id. at 925–26 (internal citations omitted).

188. Justice Scalia emphasized the necessity of state independence from direct federal compulsion to remedy perceived drawbacks to the Articles of Confederation as he notes:

The Framers' experience under the Articles of Confederation had persuaded them that using the states as the instruments of federal governance was both ineffectual and provocative of federal-state conflict. See THE FEDERALIST NO. 15 (Alexander Hamilton). Preservation of the states as independent political entities being the price of union, and "[t]he practicality of making laws, with coercive sanctions, for the States as political bodies' having been, in Madison's words, "exploded on all hands," 2 RECORDS OF THE FEDERAL CONVENTION OF 1787 9 (M. Farrand ed., 1911), the Framers rejected the concept of a central government that would act upon and through the states and instead designed a system in which the state and federal governments would exercise concurrent authority over the people

Id. at 919–20.

federal government and the states are required by the Constitution to have independent accountability to their citizenry.¹⁸⁹ These two independent lines of accountability exist so that each government serves as a check on the prospect of tyranny by the other.

The Court in *Printz* also observed that delegation of executive authority to the states would result in a violation of separation of powers.¹⁹⁰ In part, this was a consequence of the fact that the Brady Bill left local sheriffs to determine whether the handgun purchasers were in compliance with the Brady Bill.¹⁹¹ In this instance, the Levin Bill purports to be more straightforward than the Brady Bill, reading simply like an information collection requirement that does not require the exercise of executive authority in determining compliance. And yet, the Levin Bill makes precisely the same constitutional mistake that brought down the state mandate provisions of the Brady Bill. As analyzed in other Sections of this Article, however, it is clear that the uncertainties in the definitions of “beneficial owner” or “control” would in fact require states to exercise federal executive authority in determining whether an LLC is in compliance with the requirements of the Levin Bill. Therefore, state secretaries of state, who are state level executive branch officials, would be co-opted by the federal government to serve a federal regulatory role just as local sheriffs were forced to serve the same role in the invalidated provisions of the Brady Bill.

189. Justice Scalia also emphasized the importance of dual governments as key to maintaining accountability to citizens as he wrote:

The great innovation of this design was that “our citizens would have two political capacities, one state and one federal, each protected from incursion by the other”—“a legal system unprecedented in form and design, establishing two orders of government, each with its own direct relationship, its own privity, its own set of mutual rights and obligations to the people who sustain it and are governed by it.”

Id. at 920 (quoting *U.S. Term Limits, Inc. v. Thornton*, 514 U.S. 779, 838 (1995) (Kennedy, J., concurring)).

In the compound republic of America, the power surrendered by the people is first divided between two distinct governments, and then the portion allotted to each subdivided among distinct and separate departments. Hence a double security arises to the rights of the people. The different governments will control each other, at the same time that each will be controlled by itself. THE FEDERALIST NO. 51, at 323 (James Madison).

Id. at 922.

190. *See id.* at 922–23.

191. *See id.* at 927–28.

VI. ONGOING DEBATE OVER THE LEVIN BILL

A. Responding to the Bill's Proponents

One argument used by proponents of the Levin Bill is that it maintains United States compliance with international agreements on anti-money laundering, particularly Recommendation 33 of FATF (of which the United States is a member).¹⁹² As evidence of the nation's supposed noncompliance, the Levin Bill portrays the U.S. as out of step with European practices. Finding No. 10 of the Bill states that “[i]n contrast to practices in the United States, all countries in the European Union are required to identify the beneficial owners of the corporations they form.”¹⁹³ But contrary to the Bill's Finding No. 10, not “all” European Union countries require the disclosure of beneficial ownership when forming corporations. In fact, the overwhelming majority do not, including the larger European Union member states such as Germany, Italy, Spain, France, Ireland, and Great Britain.¹⁹⁴ Moreover, some of these countries even lack the legal concept of beneficial ownership,¹⁹⁵ let alone one as opaque and ambiguous as the definition of “beneficial owner” in the Levin Bill.¹⁹⁶

At least one European Union country, the United Kingdom, considered a beneficial ownership disclosure system similar to what the Levin Bill mandates, with an almost identical definition of “beneficial owner” as the Levin Bill.¹⁹⁷ According to the FATF's evaluation, the United Kingdom engaged consultants in 2002 to produce a report on the proposed system and then subjected it to public consultation.¹⁹⁸ The conclusion of this

192. ATF's Recommendation 33 states that “[c]ountries should ensure that there is adequate, accurate and timely information on the beneficial ownership and control of legal persons that can be obtained or accessed in a timely fashion by competent authorities.” See FINANCIAL ACTION TASK FORCE, THE FORTY RECOMMENDATIONS 11 (2003), <http://www.oecd.org/dataoecd/12/26/2789371.pdf>.

193. See S. 569, 111th Cong., § 2(10) (2009).

194. Other European Union countries without a beneficial ownership disclosure requirement upon incorporation include: Austria, the Czech Republic, Denmark, Finland, Greece, Hungary, Luxembourg, Portugal, Romania, Slovakia, Sweden, as well as the non-European Union countries of Norway, Switzerland, and Canada.

195. These countries are Finland, Hungary, Portugal, Romania, Slovakia, and Switzerland.

196. See S. 569, § 2009(e)(1).

197. See FINANCIAL ACTION TASK FORCE, ANTI-MONEY LAUNDERING REPORT, *supra* note 59, § 1132, at 234.

198. *Id.*

process, with respect to the proposed beneficial ownership disclosure system, was:

[T]hat there were significant disadvantages and no clear benefits, particularly when taking into account the costs of introducing such measures. Reasons included:

- disclosure of beneficial ownership would add no information of benefit Those engaged in criminal activities would not provide true information about the beneficial owners;
- disclosure would result in misleading information being included on the register. Because beneficial ownership is, as a matter of law, impossible to define precisely, any information requirement designed to require by law disclosure would have to be complex and detailed. Many ordinary, innocent shareholders would be unable to understand it or comply with it.¹⁹⁹

The United Kingdom authorities concluded that their current entity formation regime, which did not require beneficial ownership disclosure, provided investigators with as much information as could any disclosure regime, and that adding a beneficial ownership disclosure requirement “would be harmful to investigations through the resulting misleading information provided by both criminal and innocent shareholders.”²⁰⁰ The DOJ’s testimony in support of the Levin Bill ultimately offered up only one piece of evidence in support of the fact that successful money laundering prosecutions are actually hindered by the failure to obtain beneficial ownership information. When questioned about whether a lack of information about a U.S. shell company had hindered one of their investigations, “nearly all of a 75-person audience consisting of federal investigators and prosecutors from throughout the country responded that it had.”²⁰¹ These investigations were based on review of SARs filed with the Treasury Department.²⁰²

The DOJ’s analysis in this respect suffers from two flaws. First, it presumes that SARs are indicators of suspicious activity.

199. *Id.*

200. *Id.* § 1133, at 234.

201. *Examining State Business Incorporation Practices: A Discussion of the Incorporation Transparency and Law Enforcement Assistance Act: Hearing on S. 569 Before the S. Comm. on Homeland Sec. & Governmental Affairs*, 111th Cong. 3 (2009) [hereinafter *Hearing on S. 569*, Calvery Testimony] (statement of Jennifer Shasky Calvery, Senior Counsel to the Deputy Attorney General, U.S. Dep’t of Justice).

202. *Id.*

But the Patriot Act requires filing of SARs in a broad array of circumstances, and banks have strict liability for failure to file SARs, if the Treasury Department later determines they were necessary, virtually no liability for filing them.²⁰³ As a result, banks have developed procedures that inundate the Treasury Department with SARs. Even if it is accepted that the initial investigations and SAR reviews referenced by the DOJ were likely indicators of illegal activity, that does not mean that having a voluntary reporting requirement in place would solve the problem.

The second major flaw in the DOJ's analysis is that it fails to appreciate that business entities already have a requirement to maintain a link of communication with state incorporating bodies. All states require that a business entity maintain a registered agent or a person or entity that will serve as agent for service of process within the state.²⁰⁴ Many registered agents offer their services to multiple business entities. Registered agents are required by state business entity statutes to do the following:

Accept service of process and other communications directed to the limited liability companies and foreign limited liability companies for which it serves as registered agent and forward same to the limited liability company or foreign limited liability company to which the service or communication is directed; and . . . Forward to the limited liability companies and foreign limited liability companies for which it serves as registered agent the statement for the annual tax described in § 18-1107 of this title or an electronic notification of same in a form satisfactory to the Secretary of State.²⁰⁵

Business formation statutes in other states mirror this Delaware statute regarding LLC formation. As a result, formation agents require that their clients maintain current contact information with them. So the DOJ seems to be assuming that it would be unable to submit a subpoena to the registered agent to obtain the forwarding information of the LLC or other business entity or have that subpoena forwarded to the investigated entity. If this is, then it would stand to reason that the beneficial owners of entities used for nefarious purposes, who are already providing their registered agents with false information in violation of business entity statutes, would also provide false beneficial ownership information

203. See Gouvin, *supra* note 119, at 526 n.60.

204. See, e.g., DEL. CODE ANN. tit. 8, § 131 (2006).

205. See Delaware Limited Liability Company Act, DEL. CODE ANN. tit. 6, § 18-104(e)(3)-(4) (Supp. 2010).

to the same registered agents. Indeed, if the business entities used for illegal activities have provided their registered agents with false contact information, it would stand to reason that any beneficial ownership reporting forms forwarded by the registered agent would end up lost in the mail.

B. What Other Countries Have Done

The beneficial ownership reporting requirement runs counter to the practices of Canada, Mexico, Japan, and China.²⁰⁶ Only one member state in the FATF, Italy, actually requires reporting of beneficial ownership information.²⁰⁷ The Levin Bill's assertion that the U.S. is non-compliant with its FATF requirements is directly refuted by a 2007 OECD report on beneficial ownership, which maintains that:

[S]ome jurisdictions require extensive disclosure of beneficial ownership and control information up front at the formation stage and some impose an obligation to update such information when changes occur. Other jurisdictions, the majority, find they are able to rely on their compulsive power, court-ordered subpoenas and other legal measures to penetrate the legal entity in order to identify the beneficial owners when necessary.²⁰⁸

In the United Kingdom, the process of incorporating financial entities is distinctly different from the United States. First, business entities are formed by registering with a bureau called Companies House, a subdivision of Her Majesty's Treasury ("HM Treasury").²⁰⁹ HM Treasury conducted a regulatory impact study on the prospect of beneficial ownership reporting in 2002 that generated some conclusions useful for the present analysis.²¹⁰ The HM Treasury Report opened with an acknowledgement that "[t]here is a balance to be struck between the benefits of a new disclosure regime and the costs imposed on the vast majority of companies that are not involved in any sort of crime."²¹¹ It stated that:

206. See *Hearing on S. 569*, Shepherd Testimony, *supra* note 62, at 3.

207. *Hearing on S. 569*, Marshall Testimony, *supra* note 13, at 6.

208. See IDENTIFICATION OF ULTIMATE BENEFICIARY OWNERSHIP AND CONTROL, *supra* note 58, at 7.

209. Companies House, Framework Document, <http://www.companieshouse.gov.uk/about/corporateDocuments/frameworkDocument.pdf> (last visited Mar. 21, 2010).

210. See HM TREASURY, REGULATORY IMPACT ASSESSMENT, *supra* note 73.

211. *Id.* § 5.1.

[T]hose who control assets of a company set up for criminal purposes may be careful to avoid any beneficial ownership of the company's shares. . . . [C]ontrollers may be shareholders . . . creditors . . . shadow directors . . . or a third party controlling the company by blackmail, extortion, or coercion.²¹²

The HM Treasury Report also admitted that "it is a given that any person who owns or controls a company for criminal purposes will not comply with any self-certification requirement to disclose details of ownership or control."²¹³

The U.K. cost impact assessment is far more comprehensive than the cursory attention paid to cost-benefit analysis by the United States. The U.K. assessment considered that not only was precisely defining "beneficial ownership" and "control" a difficult issue for creating an entity ownership regime, but that such a regime would need to come up with simple definitions that the ordinary layman could understand for use in simple reporting forms.²¹⁴

One approach that the U.K. initially considered in determining who must register as beneficial owners was to require registration from all owners with at least three percent ownership.²¹⁵ However, this fails to take into account the fact that a business entity governing document can give full and complete governing power to a .0001% owner and no control to anyone else. Individuals intent on abusing the formation system could easily use the freedom of contract principles underlying alternative entity formation to work around hard rules, if they seek to comply with them at all. The U.K.'s RIA also targets professional intermediaries, as does the U.S. approach, by listing as an advantage the ability to threaten entity formation intermediaries with long prison sentences.²¹⁶ This also threatens the sanctity of the attorney-client relationship and goes far beyond prosecuting attorneys who assist their clients in breaking the law; rather, it forces attorneys to affirmatively investigate their clients for violations of law.

212. *Id.*

213. *Id.* § 7.1.

214. HM TREASURY & DEP'T OF TRADE AND INDUS., REGULATORY IMPACT ASSESSMENT ON DISCLOSURE OF BENEFICIAL OWNERSHIP OF UNLISTED COMPANIES: SUMMARY OF KEY ISSUES 4 (2002), http://www.hm-treasury.gov.uk/d/beneficial_condoc.pdf [hereinafter HM TREASURY, SUMMARY].

215. *Id.* at 6.

216. *Id.* at 10.

The OECD Report on the Misuse of Corporate Vehicles for Illicit Purposes calls for timely and accurate beneficial ownership information to be made available by one of three alternative measures.²¹⁷ They include up front disclosure, disclosure by intermediaries, or use of an investigative system.

C. Alternative Approaches

A new discussion draft currently being considered by the Senate Committee on Banking, Housing and Urban Development (“Banking Draft”) seeks to create a compromise beneficial ownership rule that explicitly accounts for some of these drawbacks to the Levin Bill. The Banking Draft reads directly that the Treasury Department shall have the authority to issue a beneficial ownership regulation that complies with the following restrictions:

The regulations issued by the Secretary under subsection (b) shall

- (1) be based on recommendation 33 of the “Forty Recommendations,” adopted by the Plenary of the Financial Action Task Force on Money Laundering in June 2003;
- (2) contribute to the ability of law enforcement authorities to obtain adequate, accurate, and timely information relating to the beneficial ownership and control of legal persons;
- (3) improve the efforts of the Federal Government to stop illicit financial activity and disrupt terrorist networks;
- (4) not impose undue financial burdens on States and businesses that operate lawfully; and
- (5) not impair the attorney–client privilege in Federal or State court or create conflicts between attorneys and clients;
- (6) describe in reasonable detail the provisions that must be in force for a State to be considered in compliance with this section and eligible for grants or other financial assistance to help bring it in compliance with this section;
- (7) prescribe appropriate penalties for noncompliance of any person who affects interstate or foreign commerce by knowingly providing, or attempting to provide, false information, or intentionally failing to provide information,

217. FINANCIAL ACTION TASK FORCE, THE MISUSE OF CORPORATE VEHICLES, INCLUDING TRUST AND COMPANY SERVICE PROVIDERS (2006).

that is required to be provided in compliance with the regulations issued under subsection (b), or by intentionally failing to perform any action that is required to be performed under those laws.²¹⁸

As the language of the Banking Draft presently reads, it does not affirmatively require creation of a beneficial ownership or controlling owner registry. Moreover, it does not necessarily guarantee that the Treasury Department will not use the enabling legislation to craft, by regulation, the same type of beneficial ownership reporting structure envisioned by the Levin Bill. The restrictions in the Banking Draft language that prohibit the Treasury Department from crafting a rule that does “not impose undue financial burdens on States and businesses that operate lawfully,” in particular, seems to be too vague to permit subsequent legal challenge if the Treasury Department decided to use the Banking Draft enabling legislation to enact a regime identical to that contemplated by the Levin Bill. Furthermore, even if the Treasury Department drafted regulations that comported with the Banking Draft, a subsequent appointee would remain free to change the language toward a Levin Bill-based approach. As such, the costs and drawbacks to the Levin Bill could just as easily apply to the Banking Draft.

In response to the Levin Bill, the Uniform Law Commission (ULC) drafted an alternative mechanism to address concerns about transparency and enforcement. The Uniform Law Enforcement Access to Entity Information Act (the “Uniform Act”) presents a less costly method to achieve the same outcome intended by the Levin Bill.²¹⁹

Features of the Uniform Act that differ from the Levin Bill include:

- The Uniform Act only applies to filing entities with fewer than fifty owners.²²⁰ This will limit compliance for larger entities that will find beneficial ownership tracking overly costly. The assumption underlying this provision is that the types of entities used for financial fraud and terrorism financing tend to have fewer owners.
- The Uniform Act applies to all business entities, rather than merely entities created after the Act’s enactment (an

218. S. Comm. on Banking, Housing and Urban Dev., Discussion on Beneficial Ownership Reporting (draft on file with the author).

219. UNIF. LAW ENFORCEMENT ACCESS TO ENTITY INFORMATION ACT (Tentative Draft 2009).

220. *Id.* at 1.

approach distinct from a prior version of the Levin Bill).²²¹ This will prevent criminals from using old entities to escape reporting requirements.

- The Uniform Act requires reporting entities to file with their state secretaries of state the name and business address of a responsible individual, which must be a person participating in the management and control of a business, who agrees to furnish information on beneficial ownership to law enforcement upon issuance of a subpoena.²²² Requiring the responsible individual at the company to maintain ownership records rather than keeping them on file with the state will allow legitimate companies to maintain their financial privacy. It will also ensure that the costs of compliance are borne only by the entities that are targets of law enforcement investigation. One significant argument made by the Levin Bill's proponents is that when law enforcement comes to an impasse, having at least one individual they can pressure to find the next link in the investigative trail would be beneficial.²²³ This objective can be accomplished at less cost through the responsible person provision in the ULC's recommended alternative.²²⁴

One argument that proponents of the Levin Bill have raised is that the ULC's required designation of a responsible individual at a company, who would serve as the custodian of beneficial ownership information until required to turn it over by subpoena, would give that individual forewarning of the ongoing investigation and then give him an opportunity to destroy evidence of the entity's crimes.²²⁵ And yet, that argument against the ULC proposal cuts even more strongly against the Levin Bill itself. If the businesses targeted by the Levin Bill are in fact willing to commit obstruction of justice, a much stronger offense than failure to comply with the Levin Bill, then the businesses would be even more likely to misstate beneficial ownership on forms forwarded to states of incorporation.

Testimony from the DOJ referenced a case in which an arms smuggler used U.S. shell companies for illegal arms trafficking.²²⁶ The DOJ also referenced cases in which drug smugglers used U.S.

221. *Id.*

222. *Id.* at 11.

223. *See Hearing on S. 569, Ayala Testimony, supra* note 15, at 7.

224. *See generally Hearing on S. 569, Haynsworth Testimony, supra* note 147, at 6.

225. *Hearing on S. 569, Kaufmann Testimony, supra* note 2, at 3.

226. *Hearing on S. 569, Calvery Testimony, supra* note 201, at 1.

shell corporations to launder drug proceeds.²²⁷ This does not, however, show why the wide-net beneficial ownership reporting approach is an optimal method for looking through shell companies that may be used by smugglers. The Patriot Act already provides an extensive money laundering surveillance mechanism.²²⁸ The Treasury Department could require banks, as part of their know-your-customer rules, to obtain identifying information about a minimum of one beneficial owner of an entity using the bank, particularly if the account will be used to wire money to offshore banks. This would at least have the benefit of keeping beneficial ownership information private, while limiting the imposition of onerous information collection expenses on the states. The DOJ also highlighted problems with following proceeds through foreign correspondent bank accounts in the United States that linked to foreign bank accounts and how having a clear beneficial ownership picture would render that issue moot.²²⁹ Again, it seems that the Levin Bill is intended as a patch for what the DOJ and the Treasury Department perceive as holes in the existing Patriot Act apparatus for detecting money laundering. But instead of resolving those issues by amending the Patriot Act, the Levin Bill instead seeks to sidestep the banking interest groups with a comprehensive reporting requirement on all business entities.

The ABA has determined that the approach taken by the ULC is consistent with the approach outlined in the FATF's requirements.²³⁰ The ULC's proposal is also supported by the NASS, the National Conference of State Legislatures, the International Association of Commercial Administrators, the Association of Registered Agents, and the National Public Records Research Association.²³¹ Some states have responded to DHS and DOJ concerns by instituting requirements, similar to the ULC proposal, that business entities designate a responsible person to maintain a list of beneficial owners.²³²

D. Exemptive Relief Options to Minimize the Damage

The Levin Bill casts a wide net by requiring expensive compliance for all corporations and LLCs in order to learn information about a small subset that might potentially engage in

227. *Id.*

228. *See* Pub. L. No. 107-56, tit. III, §§ 311–13, 351, 352, 359 and rules promulgated thereunder.

229. *Id.* at 2.

230. *See Hearing on S. 569*, Shepherd Testimony, *supra* note 62, at 3.

231. *Id.* at 7.

232. *Hearing on S. 569*, Marshall Testimony, *supra* note 13, at 6.

malicious activity. For instance, it might cover the professional associations of doctors, lawyers, accountants, and other professionals that are already heavily regulated under state law, and it would also cover millions of small businesses.

The NASS noted that many small businesses are already subject to reporting requirements that include beneficial ownership information. This includes those performing professional services, like doctors, lawyers, engineers, and realtors.²³³ Though this Article offers vigorous arguments against the concept of beneficial ownership reporting for corporate entities, in the event that such a regime is instituted despite this Article's arguments, one way to limit some of the damage to small businesses would be to institute regulatory exemptive relief for businesses that already file reports with a government entity that includes the names of the beneficial owners. This could include, but would not be limited to, occupational licenses, building permits, professional licenses, and other filings.

VII. CONCLUSION

The Levin Bill stands to impose tremendous compliance costs on millions of American businesses. The Bill's uncertainty over the definition of "beneficial ownership" makes honest compliance difficult, and the risks the Bill introduces of public knowledge about proprietary business information could destroy business development projects. Even more, it will do so the middle of an economic recovery. The Levin Bill also stands to impose tremendous compliance costs on state governments that adhere to its mandates at a time when state budgets are under pressure, while at the same time taking away grant money for more effective anti-terrorism measures.

The general philosophy behind the Levin Bill is founded on an erroneous assumption of reliable self-reporting of ownership information from individuals who are simultaneously engaged in fraud. It also envisions using surveillance of the business entity formation system to identify suspects engaged in terrorism finance, despite the fact that the underground banking system that those suspects are likely to use can, by its very nature, experience few of the same benefits that doing business through entities offers. Further, even if the Levin Bill augments anti-terrorism efforts in a marginal way, it offers few benefits that are not already introduced by the existing anti-money laundering provisions of the Patriot Act.

233. *Id.* at 3.

The Levin Bill also enters the arena of business entity formation with a complete lack of understanding of how the creators of business entities form their collective ownership rights and how the nature of ownership—particularly the Levin Bill's approach of defining ownership as control—is a fluid and nebulous concept that does not lend itself easily to the necessities of enforcement and compliance by unsophisticated parties. Even further, a number of constitutional challenges remain open to obviate the Levin Bill's approach.

This Article offers a definitive critique of the Levin Bill because the legislation presents a useful foil for the argument. The author's policy experience consulting with the staff of the Senate Committee on Homeland Security and Government Affairs and the Senate Committee on Banking, Housing and Urban Development suggests that some iteration of the Levin Bill is likely to be implemented soon. The approach might shift, but it will nonetheless remain tethered to the central goal of identifying ownership of business entities with the purported result of countering terrorism finance. As such, the arguments offered in this Article will remain forceful, with perhaps their force at most shifting in rank, in relation to other arguments presented in this Article, depending on the alternative mechanisms drafted into the Bill that is eventually made into law.