ALASKA LEGISLATURE COMMITTEE FILES 1993-1994 8672
7891 HOUSE JUDICIARY

(1992)[16], Iowa (1992)[17], Oklahoma (1992)[18], Minnesota (1992)[19] and Illinois[20] have enacted limited liability acts. Indiana in 1990 and Georgia in 1992 have enacted legislation permitting the registration of foreign limited liability companies.[21]

The Wyoming Act and its Revenue Ruling have become the focal point from which all states have premised their legislation. Section 7701 of the IRS Code and its accompanying regulations not only light the path for legislation in this area but warn legislators that to vary significantly may result in lost federal tax benefits. **Compliance with the state act does not assure the desired tax treatment.**

Unfortunately, the Wyoming Act still uses the old corporate act language. This has caused most other states to venture into drafting exercises of their own, sometimes onto thin ice. Care must be taken to comply with the IRS guidelines (14.100) even though state statutes may offer greater latitude. Wyoming limited liability companies are created when two or more persons file duplicate original verified Articles of Organization with the Secretary of State. W.S. § 17-15-106. A "person" is defined as

> . . . individuals, general partnerships, limited partnerships, limited liability companies, corporations, trusts, business trusts, real estate investment trusts, estates and other associations. W.S. § 17-15-102 (a)(iv).

In some states the statutory definition of "person" encompasses more. (4.600).

Limited liability companies have several useful advantages over their nearest relative, the **S corporation.** (2.153.) Limited liability companies have (1) no citizenship requirements, (2) no limitation on the size or number of members, (3) no limitation of one class of shares, (4) no limitation on ownership of other corporations, and, (5) usually, no tax penalties on liquidation, and (6) it can avail itself of § 754 code elections.

Limited liability companies have significant benefits over **limited partnerships (2.151) by allowing** limited liability to <u>all</u> members, including those who participate in management. Wyoming Statute § 17-15-113 provides that: <u>Neither the members of a limited liability company nor the managers of a limited liability company managed by a manager or managers are liable under a judgment, decree or order of a court, or in</u>

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[16] MD Code Ann. §§ 4A-101 et seq.

[17] 1992 Iowa Stat. § 490A.125.

[18] Oklahoma Title 18-2000.

[19] Minnestota Limited Liability Company Act, Chapter 322B.

[20] Illinois Limited Liability Company Act, § 5-45.

[21] Ind. Code §§ 23-16-10.1-1 et seq.

any other manner, for a debt, obligation or liability of the limited liability company. All states have similar provisions.

The main disadvantage is the restriction on transferability of the full rights of membership. Yet, a minority shareholder in a corporation is also without a meaningful right to participate in the management of that entity. Unlike the S corporation, the LLC can have broad based ownership, including corporations and trusts.

The limited liability company is a new statutory entity in its own right, separate from the corporation or the partnership. Yet, some states have restricted its potential by grafting unnecessary corporate or partnership language into their limited liability statute. Perhaps the promised model act will not restrict the LLC potential. (16.100).

## CAVEAT

**WARNING!** Blind use of these forms can be dangerous to your legal health. Prior to drafting Articles of Organization for the client, careful attention must be given to the entity being created, as it affects the desires and needs of the participants. Information along the lines of the "Client Questionnaire" and "Formation Checklist" found at page 2.300 of this book should be obtained. Once obtained, this material needs to be analyzed and discussed with the representatives of the proposed entity. A perfect world probably would contain a detailed Pre-formation Agreement which participants would sign acknowledging full disclosure by the attorney of all "opt in" features and default rules contained in the Limited Liability Company Act, and affirming that the Articles of Organization and Operating Agreement or other internal regulations contain those, and only those, features desired. The adopted Articles and Operating Agreement or other regulation amount to a contract of parties, whose interests, in certain details, may well differ.

*Limited Liability Companies, from Page 9.*

2. It has been reported that at least 17 other States are considering or have considered legislation creating LLCs. These States are: California, Georgia, Hawaii, Indiana, Michigan, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New York, Ohio, Oregon, Pennsylvania, South Dakota, and Washington.
3. *See, e.g., Ltr. Rul. 7817129* (Jan. 30, 1978) and *Ltr. Rul. 8003072* (Oct. 25, 1979) (both considering *limitadas* formed under the limited liability company laws of Brazil); *Ltr. Rul. 8221136* (Feb. 26, 1982) (considering *Gesellschaft mit beschraenkter Haftung (GmbH)* formed under the laws of the Federal Republic of Germany); *Ltr. Rul. 7826023* (March 28, 1978) (considering *sociedate por quotas de responsibilidade limitade* formed under the laws of Portugal); and *Ltr. Rul. 8006086* (Nov. 19, 1979) (considering limited liability partnerships formed under the laws of the Kingdom of Saudi Arabia).
4. It has been reported that Florida enacted its LLC statute in the hope of attracting foreign business and capital to the State from South and Central American executives familiar with the *limitada* form of business entity. *See* Comment, *The Limited Liability Company Act*, 11 FLA. ST. U. L. REV. 387, 387-388 (1983). Wyoming enacted its LLC statute as special interest legislation for an oil company. *See* Keatinge, Ribstein, Hamill, Gravelle and Connaughton, *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 383, n. 36 (February 1992) (hereinafter, "*Keatinge*"). For an examination of the history of LLCs and their earliest American and foreign precursors see *Keatinge* at 381-384.
5. *Rev. Rul. 88-76*, 1988-2 C.B. 360. Effective September 19, 1988, the Service began providing advance rulings and determination letters on the classification of LLCs. *See, Rev. Proc. 88-44*, 1988-2 C.B. 634.
6. As this article was going to press, the Service has issued private letter rulings and revenue rulings classifying LLCs as partnerships for LLCs formed under the statutes of only 6 States (excluding Wyoming). In addition to *Rev. Rul. 88-76* (with respect to Wyoming's LLC statute), LLCs formed in Colorado, Florida, Nevada, Texas, Utah, and Virginia have received partnership classification rulings. *See Rev. Rul. 93-6*, 1993-3 I.R.B. ___ (Jan. 19, 1993) (Colorado); *Ltr. Rul. 89371010* (September 16, 1989), *Ltr. Rul. 9030013* (April 25, 1990) (Florida); *Ltr. Rul. 9227033* (April 8, 1992) (Nevada); *Ltr. Rul. 9210019* (December 6, 1991); *Ltr. Rul. 9218078* (January 31, 1992); and *Ltr. Rul. 9242025* (July 22, 1992) (Texas); *Ltr. Rul. 9219022* (February 6, 1992) (Utah); and *Rev. Rul. 93-5*, 1993-3 I.R.B. ___ (Jan. 19, 1993) (Virginia). There are several other private letter rulings involving LLCs formed in the aforementioned States as well as for LLCs formed in States not disclosed in the letter ruling. These rulings are on file with the author.
7. *See, e.g.*, 1361(b), Internal Revenue Code of 1986, as amended (hereinafter "the Code"). Texas LLCs are specifically permitted to have different classes of members (TEX. CORPS. & ASS'NS. CODE ANN. art. 4.02) and LLCs in the other States are not expressly prohibited from having more than one class of interests. This provides LLCs with greater financial flexibility than an S corporation in determining allocation of losses and income since S corporations cannot specially allocate items of income and losses without violating the one class of stock restriction.
8. *See, e.g.*, 1362(d), (e), and (f) of the Code. S corporations cannot be members of an affiliated group of corporations (1361(b)(2)(A) of the Code). *See also* Keatinge, *supra*, note 4; Jordan and Kloepfer, *The Limited Liability Company: Beyond Classification*, 69 TAXES 203 (April 1991) (hereinafter, "*Jordan and Kloepfer*"); Hamill, *The Limited Liability Company: A Possible Choice for Doing Business*, 41 FLA. L. REV. 721, 748-757 (1989); Comment, *The Wyoming Limited Liability Company: A Viable Alternative to the S Corporation and the Limited Partnership?*, 23 LAND & WATER L. REV. 523 (1988); Comment, The Limited Liability Company: An Organizational Alternative for Small Businesses, 70 NEB. L. REV. 150 (Winter 1991).
9. Treas. Reg. 301.7701-1(c).
10. There are actually six relevant characteristics, but LLCs, like corporations and partnerships, will undoubtedly satisfy the two characteristics common to most business organizations: "associates," and "an objective to carry on business and divide the gains therefrom." Treas. Reg. 301.7701-2(a)(2). Generally, if an organization lacks associates and a joint profit motive, the organization will be classified as a trust. Treas. Reg. 301.7701-2(a)(2).
11. Treas. Reg. 301.7701-2(a)(3). The U.S. Tax Court in *Phillip G. Larson*, 66 T.C. 159 (1976), recognized the bias in the federal classification regulations toward a partnership classification. It noted that at the time the regulations were originally promulgated, the Service was concerned with attempts by non-corporate entities, such as professional partnerships, to qualify as corporations in order to deduct costs of medical insurance and retirement plans. 66 T.C. at 186-187. Virtually all of these advantages of corporate classification were eliminated by the Tax Equity and Fiscal Responsibility Act of 1982 and subsequent legislation.
12. *See, e.g., Phillip G. Larson, supra*, note 11. The *Larson* court majority explained the equal-weighing "as an attempt [by the Service] to impart a degree of certainty to a subject otherwise fraught with imponderables." 66 T.C. at 172. The court further stated: "we can find no warrant for such refined balancing in the regulations or in cases which have considered them. . . Our task herein is to apply the provisions of the respondent's regulations as we find them and not as we think they might of ought to have been written." 66 T.C. at 172.
13. Treas. Reg. 301.7701-2(c)(1). The managers need not be members of the LLC. Treas. Reg. 301.7701-2(c)(2). No centralized management exists if the purported manager(s) has/have authority "merely to perform ministerial acts" and does/do not have "continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization." Treas. Reg. 301.7701-2(c)(3).
14. Texas provides a "default" election with respect to centralized management. A Texas LLC must be managed by designated managers in the absence of an agreement of the members to reserve management to themselves. TEX. CORPS. & ASS'NS. CODE ANN. art. 2.12.
15. COLO. REV. STAT. 7-80-401.
16. Minnesota Act 322B.606, Subd. 1. The members can, however, supersede any action taken by the board of governors by unanimous vote. Minnesota Act 322B.606, Subd. 2.
17. Minnesota Act 322B.67. The "chief manager" partakes in the "general active management of the business of the limited liability company." Minnesota Act 322B.673, Subd. 2. The "treasurer" is the LLC's financial officer. Minnesota Act 322B.673, Subd. 3.
18. Treas. Reg. 301.7701-2(e). The term "freely transferable interests" is, in reality, a misnomer. The federal classification regulations are really referring, as a practical matter, to the transferability of the rights

-f ownership *other than* the rights to share in profits/losses and assets upon dissolution, e.g., the right to manage the business and the right to vote. Consequently, even if ownership interests in an entity can be transferred freely, the entity will not be characterized as having the corporate characteristic of freely transferable interests if there are certain limitations on the transfer of these *other* rights and attributes of ownership.

19. COLO. REV. STAT. 7-80-702; FLA. STAT. ANN. 608.432; KAN. STAT. ANN. 17-7617; NEV. REV. STAT. 86.351; VA. CODE 13.1-1039; W. VA. CODE 31-1A-34(c)(1); and WYO. STAT. 17-15-122.
20. *Rev. Rul. 88-76.*
21. Iowa Act 490A.903.1; Maryland Act 4A-601(B)(1); TEX. CORPS. & ASS'NS. CODE ANN. art. 4.07.
22. UTAH CODE ANN. 48-2b-131.
23. Arizona Act 29-731.B.2.
24. Minnesota Act 322B.313, Subd. 2.
25. *See, e.g., Ltr. Rul. 9219022*, holding that Utah's majority consent requirement was sufficient to avoid a free transferability of interests characterization. Two Service private letter rulings involving Texas LLCs have reached the same conclusion. In *Ltr. Rul. 9210019*, a Texas LLC's regulations provided as follows: interests could be transferred subject only to the consent of the LLC manager unless the manager was the transferor or was not a member of the LLC (in which case majority consent was required). In addition, no consent to a transfer of interests was required if the transfer was incident to the death, dissolution, divorce, liquidation, merger, or termination of the transferor and the transferee member constituted a "permitted transferee" under the LLC's regulations. The Service held that the LLC lacked freely transferable interests. In *Ltr. Rul. 9218078*, a Texas LLC's regulations conditioned the transfer of an interest on two-third's (2/3rds) consent of the "outstanding units." The Service held that the LLC lacked freely transferable interests. The Service's interpretation of the freely transferable interests characteristic in *Ltr. Rul. 9210019* also appears to permit Arizona and Minnesota LLCs to use their respective election provisions without being characterized as possessing freely transferable interests.
26. Treas. Reg. 301.7701-2(b)(1). These occurrences are hereinafter collectively referred to as "dissolution events."
27. Treas. Reg. 301.7701-2(b)(2). A partnership or LLC dissolution is not the same as a "termination." A termination has independent tax significance under Code 708. A partnership terminates for federal tax purposes (and State tax purposes if a State conforms to Code 708) if the partnership business, financial operation, or venture fails to be carried on by the partnership or its partners or if, in any twelve month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. Code 708(b)(1)(A) and (B).
28. Treas. Reg. 301.7701-2(b)(2).
29. Arizona Act 29-781.A.3.
30. FLA. STAT. ANN. 608.441(c) (Emphasis added).
31. KAN. STAT. ANN. 17-7622(a)(3).
32. UTAH CODE ANN. 48-2b-137(3) (Emphasis added).
33. TEX. CORPS. & ASS'NS. CODE ANN. art. 6.01(4). This article provides, in pertinent part: "... and the business of the limited liability company is continued by the consent *of the number of members or class thereof stated in the articles of organization or regulations* of the limited liability company or if not so stated, by all remaining members." (Emphasis added).
34. *See also Ltr. Rul. 9030013*, wherein the Service ruled that a Florida LLC lacked continuity of life because the LLC did not elect to use the Florida alternative, but, rather, required unanimous consent to continuation of the LLC following a dissolution event.
35. There is some authority in the federal classification regulations for the position that requiring unanimous consent from one particular class of interest is sufficient to avoid continuity of life. Treas. Reg. 301.7701-2(b)(1) provides, in pertinent part: "If the retirement, death, or insanity of a *general partner* of a *limited partnership* causes a dissolution of the partnership, unless the remaining *general partners* agree to continue the partnership or unless all remaining members agree to continue the partnership, continuity of life does not exist." (Emphasis added). A general partner interest is a different class of partnership interest from a limited partner interest. Consequently, use of the Texas alternative may not result in continuity of life if (1) the class that must consent to continuation is the class whose member has been affected by the dissolution event and (2) the Texas LLC is treated as a limited partnership for federal tax purposes. An LLC likely will be treated as a "limited partnership" by the Service, at least for letter ruling purposes. *Rev. Proc. 89-12*, 1.02, 1989-1 C.B. 798 (1.02 provides that "a 'limited partnership' includes an organization formed under a law that limits the liability of any member for the organization's debts and other obligations to a determinable fixed amount.")
36. *See, e.g.*, 6110(j)(3) of the Code and *Rev. Proc. 92-1*, 11.02, 1992 I.R.B. 9.
37. *See also Ltr. Rul. 9210019* and *Ltr. Rul. 9218078, supra* note 25. In both of these private letter rulings there was no continuity of life issue because the LLCs' operating agreements required unanimous consent of members to continuation of the LLC following a dissolution event.
38. Proposed regulations applicable to limited partnerships that the Service has recently issued may render these issues moot. These proposed regulations permit a "majority in interest of the remaining partners" to agree to continue a limited partnership upon the occurrence of any event causing the withdrawal of a general partner and still avoid being characterized as possessing continuity of life (Prop. Treas. Reg. 301.7701-2(b)(1), 57 Fed. Reg. 32473 (July 22, 1992) (PS-7-92)). Rev. Proc. 92-35, 1992-18 I.R.B. 21, also permits majority consent to continuation of a limited partnership but only if the dissolution event is the general partner's bankruptcy or removal. Consequently, for LLCs treated for federal purposes as limited partnerships, the questions surrounding continuity of life and majority consent to continuation after a dissolution event may be resolved in favor of partnership tax classification. In accordance with Rev. Proc. 89-12, *supra* note 35, an LLC should be treated as a limited partnership for federal tax purposes.
39. Treas. Reg. 301.7701-2(d)(1).
40. Arizona Act 29-651 (Arizona extends limited liability to employees, agents, officers, and non-member managers); Colo. Rev. Stat. 7-80-705; Fla. Stat. Ann. 608.436; Iowa Act 490A.601; Kan. Stat. Ann. 17-7620; Maryland Act 4A-301; Minnesota Act 322B.303., Subd. 1 (includes agents); Nev. Rev. Stat. 86.371; Tex. Corps. & Ass'ns. Code Ann. art. 4.03; Utah Code Ann. 48-2b-109 (Utah extends limited liability to employees); Va. Code 13.1-1019; W. Va. Code 31-1A-33; and Wyo. Stat. 17-15-113.
41. Treas. Reg. 301.7701-2(d)(2). LLCs eliminate any partnership-existence controversy with respect to the "limited liability" factor of the

*See Limited Liability Companies, Page 12.*

*Limited Liability Companies, from Page 11.*

federal classification regulations. Arguably, this treatment is different from what putative state law limited partnerships receive. At least one federal circuit court of appeals has suggested that the characteristic of limited liability is the most substantive factor that distinguishes corporations from partnerships. *Kurzner v. United States*, 413 F. 2d 97 (5th Cir. 1969).

42. Indeed, the Service issued proposed regulations in 1980 treating any entity vesting limited liability in all members as an association taxable as a corporation. Prop. Reg. 301.7701-2(a)(2), (g) Example (1). 45 Fed Reg. 75,709 (1980). This can be taken as a previous Service position that overall limited liability is so indicative of the corporate form that this single factor required federal tax classification as a corporation. These proposed regulations were later withdrawn. *I.R.S. Announcement 83-4*, 1983-2 C.B. 31. Moreover, the U.S. Treasury Department has in the past proposed treating limited partnerships as corporations if they had more than 35 limited partners. *See, e.g.*, U.S. Department of the Treasury, 2 *Tax Reform for Fairness, Simplification and Economic Growth–General Explanation of the Treasury Department's Proposals*, 146-150 (1984). Because of strong criticism, this proposal was never included in any tax reform package.
43. The issue of whether non-LLC states will recognize the limited liability of LLC members is also an issue which may present itself if LLCs begin operating to a substantial degree in interstate commerce. *See Keatinge, supra*, note 4 at 442–456.
44. Code 704(d). A net operating loss of a corporation can be carried forward 15 years or carried back 3 years. Code 172(b)(1)(A) and (B). A capital loss of a corporation can be carried forward 5 years and carried back 3 years. Code 1212(a)(1)(A) and (B). Taxpayers, other than corporations, may carry capital losses forward only to the next succeeding taxable year. Code 1212(b).
45. Code 441. A personal service corporation generally must select a calendar year tax accounting period. Code 441(i).
46. Under Code 706(b)(1)(B), a partnership's tax accounting period is, in order of priority: (1) the "majority interest taxable year" (*i.e.*, the taxable year of one or more partners having an aggregate interest in partnership profits and capital of more than 50 percent. Code 706(b)(4)(A)(i)); (2) the taxable year of the partnership's "principal partners" (*i.e.*, a partner having an interest in partnership profits or capital of 5 percent or more. Code 706(b)(3)); or (3) the calendar year. Partnerships may also be capable of using a "business purpose" tax accounting period under Code 706(b)(1)(C) (*i.e.*, when the partnership is engaged in a business having a "natural business year." Treas. Reg. 1.705-1(b)(4)(iii)). If the partnership cannot use the "majority interest taxable year" or the "principal partners" taxable year, the tax accounting period selected must provide for the "least aggregate deferral of income for the partners." Treas. Reg. 1.706-1T(a)(1).
47. Code 741 and 751(a).
48. *Supra*, p. 5.
49. For example, the REV. MODEL BUSINESS CORPORATION ACT requires a corporation to file articles of incorporation (2.01), hold an organizational meeting (2.05), adopt bylaws (2.06), issue shares (6.21), hold shareholder meetings (7.01), maintain a registered office and agent (5.01), appoint officers (8.40), hold board of directors meetings (8.20), and file annual reports (16.22). On the other hand, most of the LLC States require LLCs to file articles of organization, maintain a registered office and agent, file annual reports, and, if the LLC is to be managed by managers, appoint managers.
50. *See* Lederman, *Miami Device: The Florida Limited Liability Company*, 67 TAXES 339, 345 (1989). It should be noted, however, that the validity of the Service's "no separate interests" theory has not been tested by the courts. The only time a court was presented with this theory (in a case involving an unincorporated foreign business organization), it sidestepped the issue. *See MCA, Inc. v. United States*, 685 F. 2d 1099 (9th Cir. 1982).
51. 1976-2 C.B. 490.
52. *See also Rev. Proc. 89-6*, 1989-1 C.B. 776, 3.014 (Service will not rule on whether a non-U.S. LLC is a partnership if (1) the taxpayer seeking the ruling is a corporation and less than 20% of the LLC's interests are held by unrelated parties; or (2) unrelated parties hold only a nominal interest in the LLC regardless of whether the taxpayer is a corporation).
53. 1993-3 I.R.B. __ (Jan. 19, 1993). "GmbH" is the abbreviation for *Gesellschaft mit beschrankter Haftung*. *Rev. Rul. 93-4* modifies and supercedes *Rev. Rul. 77-214*, 1977-1 C.B. 408, which held that a GmbH consisting of two wholly-owned U.S. subsidiaries of the same U.S. parent possessed freely transferrable interest *and* continuity of life. *Rev. Rul. 93-4* held that the GmbH *lacked* continuity of life and provided that the presence or absence of separate interests is irrelevant to the determination of whether an entity possesses continuity of life.
54. *Supra*, note 35. The same requirement was also set forth in *Ltr. Rul. 9218078*, *supra* note 25, and *Ltr. Rul. 9147017* (August 21, 1991). This requirement has not been explicitly imposed in all private letter rulings concerning LLCs.
55. The Service should treat LLC managing members as general partners for letter ruling purposes. According to *Rev. Proc. 89-12*, 1.02, "[r]eferences to 'general partners' and 'limited partners' apply also to comparable members of an organization not designated as a partnership under controlling law and documents; the 'general partners' of such an organization will ordinarily be those with significant management authority relative to the other members."
56. The substantial interest requirement is not necessary for establishing a tax return position nor can it be applied on audit. *See Rev. Proc. 89-12*, 1.03.
57. *Ltr. Rul. 9030013.*
58. *Ltr. Rul. 9227033.*
59. *See* note 64, *infra.*
60. Wyoming and Nevada have not found it necessary to classify LLCs for tax purposes because neither state imposes a corporate or personal income tax. Wyoming does, however, impose a graduated annual fee on LLCs based on the amount of LLC capital. WYO. STAT. 17-15-132.
61. FLA. STAT. ANN. 608.471(2) and 608.426. House Bill 633, considered in the Florida legislature in 1989, would have exempted a Florida LLC from Florida's corporate income tax if it was classified as a partnership for federal tax purposes. The bill did not pass. *See* also FLA. STAT. ANN. 220.13(j) defining LLC "taxable income."
62. TEX. TAX CODE ANN. 171.001(a)(2) and (b)(1).
63. COLO. REV. STAT. 39-22-205(1) and 39-22-201.5. Recall from the previous analysis that the provisions of Colorado's statute prevent a Colorado LLC from ever possessing continuity of life or free transferability of interests.
64. Arizona Act. 29-857; Maryland Act, Title 10, 10-104(9) and 10-819(B); Minnesota Act 211B.15, Subd. 3b. Maryland characterizes

an LLC as an "unincorporated business organization." Maryland Act 4.[illegible]101(L). Maryland requires an LLC to pay a personal income tax on behalf of its non-resident members. Maryland Act 10-102.1(b).

65. *See, e.g.*, VA. CODE 58.1-301.A.; VA. INC. TAX REG. 630-3-302.15. Virginia characterizes an LLC as an "unincorporated association" for non-tax purposes. VA. CODE 13.1-1002.
66. *See, e.g.*, UTAH CODE ANN. 59-10-103(i). Code 761 defines a "partnership" for federal tax purposes in accordance with the federal classification regulations. Treas. Reg. 1.761-1(a). It also defines other terms such as "partner," "partnership agreement," and "liquidation of partnership interest." Code 761 also provides an election for certain partnerships to be excluded from partnership tax treatment under Subchapter K (*i.e.*, investment partnerships not engaged in an active trade or business, organizations availed of for the joint production, extraction, or use of property, but not availed of to sell services or property produced or extracted, and organizations engaged in the short-term selling of securities for the purpose of underwriting, selling, or distributing a particular issue of securities). *See, e.g.*, Treas. Reg. 1.761-1(a).
67. IOWA ADMIN. CODE 45.1(422).
68. KAN. STAT. ANN. 79-32,109(a). In addition, KAN. ADMIN. REGS. 92-12-8 conforms to the federal definition of "corporation." Moreover, KAN. STAT. ANN. 17-7603(b) characterizes an LLC for non-tax purposes and provides that "a limited liability company formed under this act shall be a separate legal entity and shall not be construed as a corporation." Kansas imposes an annual entity level franchise tax payable when the LLC files its Kansas report. KAN. STAT. ANN. 17-7647(c). Kansas also imposes an annual entity level franchise tax on limited partnerships. KAN. STAT. ANN. 56-1a606(d) and 56-1a607(d). The Kansas franchise tax is paid to the secretary of state and is based on an amount equal to $1.00 for each $1,000.00 of the "net capital accounts located in or used in this state at the end of the preceding taxable year as required to be reported on the federal partnership return of income." KAN. STAT. ANN. 17-7647(c). *See also* KAN. STAT. ANN. 17-7647(b)(2) which requires a Kansas LLC to provide a reconciliation of the capital accounts in the same manner that is required on the federal partnership return of income. This is further evidence that Kansas will treat LLCs the same as limited partnerships for tax purposes.
69. W. VA. CODE 31-1A-2(8).
70. W. VA. CODE 11-23-3(b)(17). West Virginia generally conforms with the Internal Revenue Code's definitions. W. VA. CODE 11-23-3a.
71. Arizona Act 29-801; COLO. REV. STAT. 7-80-901 to 7-80-913; Iowa Act 490A.1402; KAN. STAT. ANN. 17-7636 to 17-7645, and 17-7648; Maryland Act 4A-1001 to 4A-1011; Minnesota Act 322B.905; NEV. REV. STAT. 86.551; TEX. CORPS. & ASS'NS. CODE ANN. arts. 7.01 to 7.13; UTAH CODE ANN. 48-2b-143 to 48-2b-148; VA. CODE 13.1-1051 to 13.1-1060; and W. VA. CODE 31-1A-49. The twelfth state is Florida, which recognizes foreign LLCs for tax purposes. FLA. STAT. ANN. 220.13(j).
72. It should be noted that a State is not obligated to conform to the federal tax classification of an organization. *See, e.g., Commonwealth v. N.I., Inc.*, 31 Pa. Commw. 235, 375 A. 2d 898 (1977), *aff'd.*, 482 Pa. 261, 393 A. 2d 653 (1978) (Pennsylvania's non-recognition of federal S corporation status was held not to constitute a violation of the Supremacy Clause). *See also Garlin v. Murphy*, 42 A.D. 2d 30, 344 N.Y.S. 2d 402 (1973), *aff'd.*, 34 N.Y. 2d 921, 359 N.Y.S. 2d 552 (1974) (New York's non-recognition of federal S corporation status held not to constitute a violation of the Fourteenth Amendment).
73. *Supra*, notes 61 and 62.
74. *Supra*, note 63.
75. Table, *supra*, p. 7.
76. *See FTB Notice 92-5* (August 21, 1992). California's entity tax classification regulations substantially conform to the federal classification regulations. *See* CAL. ADMIN. CODE 23038(b).
77. Indiana has announced that it will classify LLCs for Indiana tax purposes in the same manner as an LLC is classified for federal tax purposes. *See Indiana Tax Policy Directive #2*, Limited Liability Companies (Ind. Dept. of Revenue, May 1992), 1992 Ind. St. Tax Rep. (CCH), 89-952. Earlier, Indiana had recognized foreign LLCs as limited partnerships for non-tax purposes. IND. CODE ANN. 23-16-10.1-1 through -4.
78. Letter dated September 20, 1991, from Myron C. Banks, Deputy Secretary, North Carolina Department of Revenue, to Dorothy Cramer (on file with the Deputy Secretary). The North Carolina Attorney General has also indicated that foreign LLCs can register to do business in the state as a limited partnership. *See*, Letter dated October 16, 1991, from Richard H. Carlton, Chief Deputy Secretary of State of North Carolina to Mr. Frank R. Liggett III, Esq., LeBoeuf, Lamb, Leiby & MacRae, Raleigh, NC (on file with the Chief Deputy Secretary).
79. *See, e.g.*, DEL. CODE ANN. tit. 30, 1901; N.J. ADMIN. CODE tit. 18, 7-1.4; N.Y. PERS. INC. TAX REG. 100.15(c).
80. *See* 1 CAVITCH, BUSINESS ORGANIZATIONS 12.01 (Matthew Bender & Co., Inc. 1988); *Klein v. Weiss*, 284 Md. 36, 395 A. 2d 126 (1978).
81. *See* 2 CAVITCH, BUSINESS ORGANIZATIONS 39.05[1] (Matthew Bender & Co., Inc. 1988); *Dwinell's Central Neon v. Cosmopolitan Chinook Hotel*, 21 Wash. App. 929, 587 P. 2d 191 (Wash. Ct. App. 1978); *Klein v. Weiss*, *supra*, note 80.
82. The Indiana and North Carolina attorneys general have ruled that an LLC will be treated as a limited partnership in those States. *Supra*, notes 77 and 78.
83. California *FTB Notice 92-5*, *supra*, note 76, does not indicate whether LLCs will be treated as limited or general partnerships. Characterization as a limited or general partnership has tax consequences in California because a limited partnership doing business in California is required to file a partnership information return under CAL. REV. & TAX CODE 17932 and pays a minimum tax of $800. CAL. REV. & TAX CODE 23081.

    Other States may treat limited partnerships (or limited partnerships not electing particular tax treatment) as corporations for tax purposes. *See, e.g.*, ARK. ADMIN. REG. Art. 4.84-2002(7); N.J. DEPT. OF TREAS.–TAXATION REG. 18:7-1.5; and PENN. DEPT. OF REV. REGS. 153.1(a)(3), (9), and (b)(3). A number of states impose entity level income or franchise taxes generally on unincorporated business associations. *See, e.g.*, D.C. CODE ANN. 47-1808.3 (unincorporated business franchise tax); HAWAII REV. STAT. 237-1 (gross income tax on partnerships doing business in Hawaii); ILL. REV. STAT. ch. 120, 2-205(b) (personal property replacement tax on the net income of all business organizations with activities in Illinois); MICH. COMP. LAWS 208.6(1) ("single business tax" on all business organizations with Michigan business activities); N.H. REV. STAT. ANN. 77:14 (business profits tax

*See Limited Liability Companies, Page 14.*

*Commodity Year Book.* Commodity Research Bureau, Inc. Annual.
*Daily Market Record.* Daily.
*Statistical Annual: Grains, Options on Agricultural Futures.* Chicago Board of Trade. Annual.
*United States Census of Agriculture. Bureau of the Census.* Quinquennial. Most recent: 1982.

**CORNER** "Control or monopoly over a commodity or security to get control of or to dictate prices" (S. S. Pratt, "Work of Wall Street"). Technically, a corner occurs on a stock exchange when shorts cannot borrow stock, i.e., have sold more stock than the floating supply makes available for purchase. Those who have a corner can dominate the situation and dictate price terms to their unfortunate victims—the shorts who are forced to settle at artificially dictated prices, thereby incurring heavy losses. The two important corners in stocks were the Northern Pacific corner (1901) and the Stutz corner (1920).

Corners have been more frequent in grain than in stock speculation and in most cases have proved disastrous for their promoters. The three great corners on the Chicago Board of Trade are known as the Hutchinson corner (1888), the Leiter corner (1898), and the Patten corner (1909). An attempt to corner silver occurred in the 1980s.

A corner has been declared to be illegal by the courts for two reasons: it is a gambling transaction and contracts thereunder are therefore unenforceable, it is in restraint of trade.

Under the COMMODITY EXCHANGE ACT and its successor the Commodity Futures Trading Commission Act of 1974, the Commodity Futures Trading Commission can set limitations both upon the amount of speculative trading done daily by any one individual and upon the speculative net position, long or short, of any speculative account at any one time, and requires the reporting to it of any holdings in excess of certain amounts. Under the Securities Exchange Act of 1934, operations of the stock exchanges and their members, and of security brokers and dealers generally, are subjected to regulation of the Securities and Exchange Commission.

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**CORN-HOG RATIO** The number of bushels of corn equal in value to 100 pounds of hog, liveweight, which indicates at market prices the relative attractiveness to farmers of selling their corn or feeding it to their hogs for hog marketing.

In addition to the corn-hog ratio, the Department of Agriculture also regularly compiles other local market commodity-feed price ratios, such as the egg-feed ratio (pounds of laying feed equal in value to one dozen eggs), broiler-feed ratio (pounds of broiler grower equal in value to one pound of broiler, liveweight), turkey-feed ratio (pounds of turkey grower equal in value to one pound of turkey, liveweight), and milk-feed ratio (pounds of concentrate ration equal in value to one pound of whole milk).

**CORN PIT** *See* PIT.

**CORPORATE AGENT** A person or firm empowered to act for another. Banks serve as corporate agents for a fee in various capacities for corporations, state and local governments, municipalities, and persons, including the following:

1. **Stock transfer agent.** Banks maintain stock transfer books and shareholders' ledger when retained by a corporate client.
2. **Stock registrar.** Banks serve as stock registrars who countersign stock certificates and ensure that each certificate is properly issued.
3. **Coupon and bond paying agent.** Banks and trust companies occasionally pay maturing coupons and principal of corporate clients. Paid coupons and bonds are cremated and either a cremation certificate or the paid coupons and bonds are returned to the principal.
4. **Dividends disbursing agent.** Banks pay dividends to stockholders of record and provide a report to the corporation of such disbursements when retained to do so.
5. **Fiscal agent.** Banks serve as fiscal agent for a government, especially for taxes withheld that are deposited with it for the account of the government.

**CORPORATE RECORDS** Those records of a CORPORATION required by incorporation laws and pertaining to its corporate character. Among these are the certificate of incorporation, bylaws, book of minutes of the board of directors, stock book, stock transfer book, etc. Section 10 of the New York Stock Corporation Law requires that every stock corporation keep at its office correct books of account of all its business and transactions and a stock book showing the names of all persons, alphabetically arranged, who are stockholders of the corporation, their addresses, number of shares of stock held, the time when they became stockholders, and the amount paid thereon.

**CORPORATE STOCK** In municipal financing, sometimes used as the title for bonds of long-term maturity, with sinking fund retirement and other characteristics of bonds.

*See* MUNICIPAL BONDS.

**CORPORATE TRUSTS** *See* TRUST.

**CORPORATION** **The corporate form of business organization is dominant in the U.S. in manufacturing and wholesale trade both in number of firms and in operating terms (sales, employees). In retail trade and the service industries, corporations are** in the minority numerically but account for more sales and employment than unincorporated firms (U.S. Bureau of the Census, U.S. Census of Business). This dominant position of the corporation as to size of operations underscores the major financial and managerial advantages of the corporate form. Financially, the corporate form structurally facilitates more extensive financing for a firm for the following reasons.

1. **Limited liability.** When stockholders become investors in a corporation they can foretell the limits of maximum loss (the extent of the investment), without personal liability for debts of the firm, unlike the case for the proprietorship and the general partnership.
2. **Separability of investor and managerial motivations.** The investor who is not interested in active participation in management may invest in nonvoting stock or, where he invests in voting stock, may by proxy designate persons to vote for him, in his name, place, and stead, in elections of directors and on other corporate matters. In either case, management may be delegated to others (the directors, who in turn appoint the officers). If the stockholder is so motivated, he may participate actively in election of directors or become a member of the board of directors and/or member of the officers to the extent that his voting power and qualifications justify. The corporation's capitalization may be appropriately proportioned as to debt, nonvoting stocks, and voting stocks.
3. **Divisibility and transferability of ownership.** The corporation's total ownership is divisible into an appropriate number of units (shares of stock) by the device of par value (or if no par value stock is issued, by number of shares with suitable stated value per share). Such conveniently sized units of ownership may be sold to a larger number of investors, as contrasted to total lump sum proprietorship interest or proportionate interests of partners. Further, a fundamental right of stockholders is to receive certificates of ownership, which may be readily assigned to new owners and/or transferred, heightening marketability.
4. **The absence of "delectus personae" among stockholders** (the personal right of general partners to choose their associates as partners). Each and every stockholder of a particular class of stock is entitled to all the rights and privileges applicable to all other holders of that class of stock. Existing stockholders cannot refuse to admit new stockholders to full status as such.
5. **Separate legal existence of the corporation as an entity, apart from its owners, creditors, and agents** (directors, officers, employees, etc.). Because the corporation may own, buy, and sell property in its own name; make contracts; sue and be sued in its own name; exercise all its express, implied, and incidental authorized powers, it may continue its separate existence, with its own financial integrity, apart from turnover of such individuals, pursuant to its charter. Such durability of existence facilitates long-term financing.

A *de jure* corporation is one formed in compliance with the pro-

visions of an incorporation statute. A *de facto* corporation is one formed without full compliance with all material, mandatory provisions of an incorporation statute.

Corporations are also classified as public or private. Private corporations may be stock or nonstock corporations. Stock companies normally operate for profit, while nonstock corporations such as certain hospitals and churches usually are not-for-profit organizations. Corporations also can be classified as follows:

1. Public corporations are government-owned entities such as the Federal Deposit Insurance Corporation.
2. Open corporations are private stock corporations whose stock is available to the public and is usually traded on a stock exchange (a listed corporation) or in the over-the-counter market (unlisted).
3. Closed corporations are private corporations whose stock is not offered for sale to the general public but is usually held by a few individuals.
4. Domestic corporations are incorporated in a particular state. Foreign corporations operate in a state other than the one in which they are incorporated.

Managerially, the corporate form, aside from its general advantage of assembling skills, money, and property, especially facilitates use of the line and line and staff types of internal organization for large-scale operations, making possible functionalization and decentralization of operations with centralization of responsibility and accountability maintained.

The rise of the corporation as the most important form of business organization was especially facilitated in the latter part of the last century by enactment of general incorporation statutes among the states, making it possible for any group of incorporators complying with the objective statute's requirements to form corporations freely. By contrast, the previous system of special acts of the legislatures for chartering corporations inhibited new incorporations by making it possible for existing corporate interests to block the new charters by political pressure.

The corporation is a creature of statute, both as to procedure for formation and subsequent exercise of permissible powers, but the corporation is legally protected against arbitrary impairment of charter powers by the sovereign, the state, because the corporate charter is a contract that the state of incorporation may not impair (*Dartmouth College* v. *Woodward*, 4 Wheat. 518 [1819]). The corporation, although a legal entity, has no freedom of movement, as natural persons have, to do business in any state; as a foreign corporation seeking to do business in other states, it may validly be required to be licensed and designate agent therein for service of process in case of litigation. As a creature of statute, the corporation may be subjected to nonarbitrary or discriminatory regulation, especially in such fields as banking, insurance, and other regulated lines of activity.

Since the corporation is a separate legal entity, it is itself the legitimate object of taxation, both federal and state, both organizational taxes (incorporation fees, annual franchise taxes) and operational taxes (income, property, and excise taxes). This leads to the disadvantage for stockholders of double taxation (the corporation pays taxes and stockholders pay income taxes on dividends declared and distributed). To the extent of properly retained earnings, the corporation may legitimately avoid such double taxation. Intercorporate dividends are taxed only at their tax rate on only 15% of the dollar amount, so that, for example, at a 46% tax bracket for the corporation, the net tax is 6.9%, which constitutes welcome relief from the double taxation. The giant corporation of modern times is likely to be either purely or partly a HOLDING COMPANY, owning interests in other corporations.

The growth of giant corporations led some early observers (e.g., A. A. Berle, Jr., and G. C. Means, *The Modern Corporation and Private Property*, 1933) to view with alarm the concentration of industry in relatively few corporations and, projecting such growth, to conclude that the giant corporation was a threat to government itself. Other observers viewed with misgivings the impersonal nature of the corporation, hiding its principals behind its corporate veil and giving rise to a new professional class—the managers—normally insulated against effective accountability to independent stockholders because of massive proxy voting. The dire projections of concentration, however, have been modified by growth of the economy as a whole. Proxy battles for control indicate the vulnerability of arbitrary managements; the emphasis by giant corporations upon stockholder relations and public relations indicates responsibility as compared with the predatory irresponsibility of the latter part of the nineteenth century. And government, with its proliferations of laws and administrative agencies in regulation of business, has not been taken over by the corporation.

*See* PARENT COMPANY.

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**CORPORATION BONDS** Obligations of a business corporation as distinguished from civil bonds, obligations of a governmentality (federal, state, or municipal government).

The soundness of corporation bonds depends upon many factors including the character of collateral offered, the character of the issuer, the nature of the industry, and the stability of its earnings. The market value of corporation bonds is primarily influenced by money rates in the case of highest grade obligations, and business activity and conditions in the case of lower grade issues, while civil bonds of fiscally sound public bodies are primarily influenced by the level of money rates.

*See* BOND, INDUSTRIAL BONDS, INVESTMENT, PUBLIC UTILITY BONDS, RAILROAD BONDS.

**CORPORATION FINANCE** The division of finance that deals with the promotion, organization, capitalization, financing, reorganization, and financial conduct of business corporations. "Corporation finance aims to explain and illustrate the methods employed in the promotion, capitalization, financial management, consolidation, and reorganization of business corporations" (S. E. Mead, *Corporation Finance*, 1910). The descriptive approach of pioneer texts, emphasizing legal and accounting aspects of the subject, continues to be fundamental in modern works, but added thereto has been more emphasis on theory and decision-making, particularly from case materials, accentuating the managerial approach.

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**CORPORATION PAPER** Notes, acceptances, and bills of exchange issued by corporations, as distinguished from paper issued by individuals and copartnerships.

**CORPORATION: TAX FORMULA** The computation of the federal income tax liability for a corporation is presented here:

THE
FOLLOWING
DOCUMENTS
ARE
POOR
ORIGINAL
COPIES

**Sample Certificate of Participation**

No. _____

$ _____

CERTIFICATE OF PARTICIPATION
issued by
Blank National Bank of New York

has allotted to _____ Bank
in participation of _____
in a note for $ _____
made by _____
dated _____
with interest at _____ % per annum.

**PARTICULAR AVERAGE** In marine insurance, insurance with particular AVERAGE, without limitation of percentage, covers any partial loss resulting from marine perils.

**PARTIES** The parties to a check are the drawer, payee, drawee, and endorsers; to a draft or bill of exchange, the DRAWER, DRAWEE (called acceptor after he accepts it), payee (often the same party as the drawer), and endorsers; to a note, the MAKER, PAYEE, and endorsers.

**PARTNER'S CAPITAL** The amount of money contributed by the partners of a firm for investment in the partnership business. This term is also sometimes applied to the capital contributed by the stockholders of a corporation, presumably represented by the aggregate amount of preferred and common stock outstanding, as distinguished from the amount of capital represented by bonds and other forms of fixed indebtedness. Stocks are sometimes referred to as share capital, while bonds, notes, mortgages, debentures, equipment trust certificates, etc., are called loan capital.

**PARTNERSHIP** A general partnership is a form of business organization in which two or more persons (no limit as to the number) are associated as coowners for the purposes of business or professional activities for private pecuniary gain. Each general partner is a general agent for the others and may bind the partnership for acts within the scope of the partnership's business. It is a contractual relationship needing no written partnership agreement to arise. It is preferable, however, to prepare written articles of copartnership, especially in order to define the duties of each partner and respective authorities which will be binding as among the partners and to specify the agreed sharing of profits and losses which otherwise in the absence of specification will be implied to be equal.

As distinguished from the corporation, the general partnership requires no formal legal proceedings in the form of charter or franchise from the state, although legal incidents of the general partnership have been enacted by all states except Georgia and Louisiana by their versions of the Uniform Partnership Law, declaratory of common law principles which will otherwise prevail in other jurisdictions which have not enacted statutes. Moreover, the general partnership has no separate legal existence apart from the partners, and so is not taxed as a firm for income tax purposes as is the corporation. Because of such lack of legal entity, however, the general partnership is subject to unlimited personal liability by the general partners for any of the partnership debts, each general partner being jointly and severally liable for the firm debts. In recovering from personal assets of the partners, however, firm creditors are subject to the rule of marshaling of assets, pursuant to which personal creditors have first claim upon personal assets in the event of conflict as to priorities. In turn, personal creditors are subject to the firm creditors' first claim upon firm assets. In addition, because of the lack of legal entity for the general partnership as a firm, the firm's existence is very fragile, being subject to *dissolution* (not necessarily *liquidation* in each case) by reason of the death, withdrawal, bankruptcy, or legal disability of any of the general partners. Usually such lack of permanence of duration of the firm is a disadvantage insofar as long-term firm financing is concerned. This factor, as well as the divisibility of ownership into conveniently sized units (shares) enjoying limited liability and transferring readily without legal difficulty, makes the corporation the feasible form of business organization where substantial external financing is required for a firm.

Unlike the general partnership, the limited partnership is purely statutory and will arise by implication and without written articles of copartnership. A limited partnership is formed by express written agreement, pursuant to statute of the home state, between one or more general partners and one or more limited partners. The limited liability feature applies only to the limited partners, provided they are merely investors in the firm and actually do not have a voice in the management. The general partners in the limited partnership are subject to all the legal incidents of general partnership law. Most states have enacted their versions of the Uniform Limited Partnership Act. A limited partnership, like the corporation and unlike the general partnership, has no freedom of movement and will be simply a general partnership in any jurisdiction other than the home state of creation. State procedural requirements for the creation of the limited partnership, including the filing of a certificate or articles of partnership and publication thereof, are not onerous. Specific compliance, however, is necessary in order to achieve limited liability for the limited partners. Moreover, the limited partners' claims as to withdrawal of capital investment, sharing in profits, or withdrawal of loans to the firm must not impair the ability of the firm to provide for firm creditors. As investor-partners, however, limited partners enhance the financial resources of a partnership, the usual motivation for such form of organization. The disadvantage of impermanence of the firm because of the dissolution incidents of the general partnership will also apply to the limited partnership insofar as the general partners are concerned. As far as the limited partners are concerned, their withdrawal pursuant to agreement or transfer of their interest will not work a dissolution of the firm. A limited partner may legally demand a dissolution, however, if after notice and without injury to the claims of creditors, the return of his investment is not forthcoming.

Other forms of partnership are the following:

1. The joint venture modified as to (a) limitation of existence for a single undertaking or specified period, and (b) centralized authority in the manager.
2. The mining partnership modified as to (a) coownership only as to profits, tenancy in common of the individuals as to the mine; (b) possibility of issuance of stock for transferable ownership interests in the mine; (c) no general agency authority in each of the partners to bind the partnership within the scope of the business, a manager usually having limited authority for necessary labor, supplies, etc.; and (d) personal liability of partners for firm debts incurred while they were owners or until notice of retirement is given to creditors.
3. The limited partnership association modified as to (a) formal organizational procedure, akin to that of the corporation, including organization tax; (b) legal entity for the firm so that limited liability applies; (c) division of the capital into shares of stock; (d) election by the shareholders of a board of managers or directors akin to that of the corporation; (e) transferability of stock subject to the requirement that new shareholders must be accepted by a majority of the existing stockholders in order to vote. Should the new shareholder be denied election, he may, pursuant to law, demand the purchase of his shares by the association, either by negotiations or pursuant to appraisal by court-appointed appraiser. This requirement for cash might prove embarrassing to the liquidity of the firm. Like the limited partnership and corporation, the limited partnership association is a creature of statute of the home state and will not have freedom of movement as such into other states. Only four states provide for this variation of the partnership, with their own variations of the form in each case.

Partnerships are treated as separate accounting entities from the partners. A partner's capital interest in a partnership is a claim against the net assets of the partnership as reflected in the partner's capital account. A partner's interest in profit and loss determines how the partner's capital interest changes as a result of subsequent operations.

Advantages associated with the partnership form of business organization include the ease of formation and dissolution, its ability to pool capital and personal talents and skills, its nontaxable status for income tax purposes, and the relative freedom and flexibility partners enjoy in business matters. Disadvantages of

partnerships include their limited life, the ability of a partner to commit the partnership in contractual matters, the unlimited personal liability of partners, and the difficulties of raising large sums of capital and of transferring ownership interests as contrasted with the corporate form of business organization.

A person may become a partner in an existing partnership by purchasing an interest from one or more of the existing partners and by investing cash or noncash assets in the partnership. A person can be admitted to a partnership only with the consent of all continuing partners in the new partnership enterprise.

The tax bases for assets contributed by the partners to the partnership are the same tax bases that applied to the individual partner making the contribution. The tax basis of a partner's interest in capital of a partnership is the sum of the tax bases of the assets contributed by the partner, increased by the personal liabilities of other partners which the partner assumes, and decreased by the partner's personal liabilities assumed by other partners. The sum of the tax bases of the partnership assets equals the sum of the tax bases of the partners' separate interests in capital.

**Summary.** Numerically, business firm population in the United States is about 80% simple proprietorships, with 10% partnerships and 10% corporations. Corporations account for the bulk of business assets, sales, and employment in the aggregate. This reflects their advantages for assembling large aggregations of capital. The partnership form is required in some states for firms involved with professional responsibility of a personal nature to clients. Law and accounting firms are often formed as partnerships.

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**PAR VALUE** Face value or nominal value.

**Bonds.** The par or face value of a bond is the principal amount (denomination) at which the obligor (issuing corporation) contracts to redeem the bond at maturity. It is also the basis upon which the cash interest rate on the bond is computed. Although bonds are usually originally issued at an interest rate sufficiently attractive to assure their sale approximately at par or at slight discount, they will subsequently fluctuate in accordance with the trend of money rates and yields (if high-grade) and general business conditions (if second-grade or speculative) and earnings available for charges of the issuer. Whether a bond commands an open market premium or discount, the closer it approaches maturity, the closer the market value should approximate the par value, unless there is serious question about the ability to repay or refund by the issuer. At the date of maturity, it should be worth precisely par, since that is its redemption value. In the United States, business corporation bonds are usually issued in denominations of $1,000, although $500 and $100 denominations are not infrequent. Higher denominations such as $5,000 and $10,000 occur in relatively fewer instances, designed for institutional investors.

**Stocks.** The par or face value of shares of stock is not uniform, although $100 was formerly the most common par value. Shares may be given any specified par value, e.g., $50, $25, $10, and even smaller or odder denominations especially as the result of split-ups. In speculative enterprises, such as in the oil and mining industries, the par value of shares is usually small, and in turn the number of shares on a given dollar amount of capital is large. This is done in order to attract a wider market than would be possible if shares were of higher par value and hence there were fewer shares on a given dollar amount of capital, resulting in higher per-share figures for earnings, asset value, dividend (if any), and market price. In many states, shares may be issued without par value, in which cases the shares are assigned a stated or declared value for purposes of the capital stock account. In relatively rarer cases, par value of business corporations may be a multiple of $100, e.g., $500, $1,000, etc.; this may be done by privately owned or closely held corporations to restrict the number of holders. The significance of par value is that it must be fully paid (in the case of business corporations, issuable for cash, property, or services) in order that the stock may attain nonassessable status (limited liability). In the case of no par value shares, the subscription price must similarly be fully paid, even though the stated or declared value may be a fraction of the subscription price. But the subscription price on subsequent issues may be varied flexibly in line with market conditions as compared with the rigid par value requirement in the case of par value shares.

The treasury stock device in connection with the promotion of new speculative enterprises has been rendered obsolete by no par value shares and by fractional par values (something less than $100). That device would call for issuance of stock to the promoter for his services (subject to a test of reasonableness of the value thereof) at full par value. Next, the promoter would then donate back to the corporation a portion of his holdings, allowing the corporation thereafter to sell the treasury stock thus donated at any price to investors in the speculative venture, such resold treasury stock being entitled to fully paid and nonassessable status (having been originally issued at full par value). Thus the new corporation would be able to raise cash needed for the venture.

*See* WITHOUT PAR VALUE STOCK.

**PASS A DIVIDEND** When a board of directors omits to declare a regular or expected dividend, it is said to pass a dividend.

**PASSBOOK** A bank book; a book in which deposits, or deposits and withdrawals, are recorded. Passbooks are provided for both commercial and savings accounts. In commercial checking accounts the passbook is merely a memorandum of deposits. It is neither a book of original entry nor a statement of account. The DEPOSIT SLIP is the original entry and the important record from a legal point of view. Unlike the savings bank passbook, the nonsavings account passbook is not a contract. Entries should not be considered as absolute receipts admissible as court records, but rather as acknowledgments of receipts of deposits corresponding in amount to the footing of the accompanying deposit slips. It is not necessary to present a passbook when making deposits in a commercial checking account. It is only necessary to fill out a deposit slip, a duplicate being rendered if desired. The acceptance of a deposit for absolute receipt and credit, except for cash, is usually conditional upon the collection and payment of such deposit. Deposits of checks, in other words, are subject to final payment and therefore to cancellation of credit for such portions as may be returned unpaid.

In order that commercial depositors may understand the purpose of a passbook and the conditions under which deposits are accepted, a notation such as the following should be imprinted on the flyleaf.

> This passbook is issued for the convenience of customers and is intended for a record of deposits only. It is not a book of original entry, nor a statement of account. Statements of account will be rendered monthly.
>
> All items, other than money, are subject to cancellation of credit if not paid on presentation. It must be understood that the liability of the bank is limited to the observance of due diligence in selecting its immediate correspondents for the presentation and collection of items in this city and elsewhere and that the endorsement "Pay to any bank or banker," or its equivalent, shall not exceed such liability, and this bank will not be responsible for loss of any kind due to the acts of negligence of such correspondents in the selection of subagents for presentation and collection, etc., or for loss in or through the mails, or for any failure to present, demand, or collect on any Saturday or holiday.

The status of a savings account passbook is legally very different from that issued for a checking account. In savings bank practice, it is used as a voucher or receipt, both for money deposited and for money withdrawn. It must be presented whenever a deposit or withdrawal is made, and periodically for the credit of interest

**Table 1 / Life Insurance—Insurance in Force and Benefit Payments by State: 1986**
(Expenditures to policyholders and payments in the U.S.)

| Region, Division, State | Insurance in Force | | | Benefit payments [1] |
|---|---|---|---|---|
| | Policies (1,000) | Value (bil. dol.) | Average per household (dol.) | (mil. dol.) |
| | 394,883 | 7,452 | 82,800 | 71,432 |
| | 83,229 | 1,686 | 89,800 | 19,665 |
| Northeast | 97,407 | 1,854 | 83,700 | 18,907 |
| Midwest | 154,709 | 2,496 | 80,800 | 20,562 |
| South | 59,538 | 1,416 | 77,800 | 12,298 |
| West | 20,893 | 443 | 92,500 | 4,567 |
| New England | 1,935 | 31 | 68,800 | 291 |
| Maine | 1,667 | 33 | 85,000 | 305 |
| New Hampshire | 852 | 15 | 73,600 | 169 |
| Vermont | 8,755 | 200 | 91,300 | 2,108 |
| Massachusetts | 1,823 | 31 | 85,300 | 304 |
| Rhode Island | 5,861 | 133 | 111,700 | 1,390 |
| Connecticut | 62,336 | 1,243 | 88,900 | 15,098 |
| Middle Atlantic | 27,958 | 590 | 87,800 | 7,498 |
| New York | 12,042 | 286 | 102,000 | 3,365 |
| New Jersey | 22,336 | 367 | 82,500 | 4,235 |
| Pennsylvania | 69,832 | 1,304 | 84,200 | 13,690 |
| East North Central | 18,451 | 334 | 82,900 | 3,483 |
| Ohio | 9,099 | 161 | 78,500 | 1,641 |
| Indiana | 19,907 | 388 | 90,800 | 4,160 |
| Illinois | 14,510 | 283 | 84,400 | 2,981 |
| Michigan | 7,865 | 138 | 77,100 | 1,425 |
| Wisconsin | 27,575 | 550 | 82,500 | 5,217 |
| West North Central | 6,221 | 139 | 87,500 | 1,252 |
| Minnesota | 4,578 | 86 | 80,200 | 998 |
| Iowa | 8,324 | 153 | 79,100 | 1,402 |
| Missouri | 991 | 21 | 84,300 | 154 |
| North Dakota | 905 | 19 | 73,000 | 178 |
| South Dakota | 2,427 | 52 | 84,600 | 525 |
| Nebraska | 4,129 | 80 | 84,700 | 708 |
| Kansas | 79,754 | 1,281 | 81,800 | 10,898 |
| South Atlantic | 1,313 | 26 | 109,000 | 238 |
| Delaware | 8,192 | 154 | 92,700 | 1,534 |
| Maryland | 2,053 | 46 | 185,600 | 337 |
| District of Columbia | 13,284 | 203 | 93,500 | 1,471 |
| Virginia | 3,090 | 40 | 56,900 | 435 |
| West Virginia | 13,498 | 186 | 77,900 | 1,517 |
| North Carolina | 7,757 | 96 | 79,800 | 664 |
| South Carolina | 12,646 | 208 | 92,200 | 1,427 |
| Georgia | 17,921 | 322 | 67,300 | 3,275 |
| Florida | 32,949 | 412 | 73,800 | 3,325 |
| East South Central | 6,069 | 86 | 62,800 | 710 |
| Kentucky | 9,988 | 143 | 78,600 | 1,348 |
| Tennessee | 12,704 | 123 | 83,200 | 849 |
| Alabama | 4,188 | 60 | 65,600 | 418 |
| Mississippi | 42,006 | 803 | 83,100 | 6,339 |
| West South Central | 2,766 | 47 | 53,000 | 401 |
| Arkansas | 9,065 | 129 | 82,600 | 1,031 |
| Louisiana | 4,445 | 87 | 96,700 | 916 |
| Oklahoma | 25,730 | 540 | 90,500 | 3,991 |
| Texas | 19,007 | 370 | 77,500 | 3,214 |
| Mountain | 1,109 | 21 | 67,800 | 197 |
| Montana | 1,308 | 23 | 65,000 | 215 |
| Idaho | 630 | 13 | 74,900 | 125 |
| Wyoming | 5,303 | 113 | 90,000 | 942 |
| Colorado | 1,858 | 36 | 68,400 | 308 |
| New Mexico | 5,057 | 94 | 75,400 | 865 |
| Arizona | 2,437 | 45 | 87,600 | 364 |
| Utah | 1,305 | 25 | 62,800 | 198 |
| Nevada | 40,531 | 1,046 | 77,900 | 9,084 |
| Pacific | 5,025 | 125 | 71,100 | 1,135 |
| Washington | 3,310 | 68 | 63,300 | 674 |
| Oregon | 29,674 | 800 | 79,400 | 6,832 |
| California | 656 | 15 | 84,800 | 123 |
| Alaska | 1,866 | 38 | 112,000 | 320 |
| Hawaii | | | | |

[1] Includes death payments, matured endowments, disability and annuity payments, surrender values, and policy dividends.
Source: American Council of Life Insurance, Washington, DC, *Life Insurance Fact Book Annual*.

**LIMIT** The definite price fixed by a customer in an order placed with a broker to buy or sell securities or commodities. A limit order is to be executed at the limit or better; e.g., a buy order for a round lot of X(U.S. Steel) at 70 shall be executed at a price of $70 per share or less; or a sell order of a round lot of J (Standard Oil of New Jersey) at 42 shall be executed at price of $42 per share or higher.

*See* ORDERS.

**LIMITATIONS** *See* ACCEPTANCE CREDIT, NATIONAL BANKING SYSTEM, STATUTE OF LIMITATIONS.

**LIMITED COMPANY** The term "Company," "Co.," "& Co.," or "& Company" in a firm title, without further wording indicating that the firm is corporate in nature, may indicate either a general or a limited partnership. In the latter form of business organization, which shall consist of one of more limited partners and one or more general partners, the limited partner(s) is not liable personally for firm debts, being limited in his liability to his investment in the firm.

The term "limited" in English terminology refers to the corporation whose stockholders, provided they hold fully paid and nonassessable shares, are not liable personally for firm debts. In American practice, the corporate form of organization is indicated by reference to "Corporation," "Corp.," "Incorporated," or "Inc." in the firm title.

Limited partnership associations are provided for statutorily in four states in the U.S. This type of organization is corporate in nature, with limited liability, division of ownership into shares of stock, and voting for a board of directors or managers. The shares may be transferred, but the transferee must be elected to membership by majority of the members and of the total shares of stock in order to be entitled to the voting privilege. A quirk of this form is that such transferee not elected to membership is entitled to the firm's purchase of his shares at fair value.

The business trust, also called the Massachusetts trust, may also enjoy limited liability for its beneficiaries (holders of transferable certificates of beneficial interest in the trust), but if such beneficiaries have the power of voting for the trustees, limited liability fails because of violation of the basic principle of the trust (power of beneficiaries to vote for or fail to reelect trustees implies control over legal title to the corpus [assets] and hence a merger of the legal and equitable interest), and so a mere partnership may be deemed to result, with personal liability for firm debts.

*See* CORPORATION, LIMITED LIABILITY.

**LIMITED LEGAL TENDER** *See* LEGAL TENDER, TOKEN MONEY, UNITED STATES MONEY.

**LIMITED LIABILITY** The liability of stockholders of the ordinary business corporation extends no further than to payment of the full par value of the issued and outstanding capital stock, such limited liability being one of the principal advantages of the corporate form of business organization. However, even for limited liability corporations, state statutes provide that every holder of shares of stock not fully paid shall be personally liable to the creditors of the corporation to an amount equal to the amount unpaid on the shares held by him for debts of the corporation contracted while such shares were held by the stockholder. Also, state statutes, e.g., New York's, provide that the stockholders of every stock corporation shall jointly and severally be liable personally for all debts due and owing to any of the corporation's laborers, servants, or employees other than contractors for services performed by them for such corporation under specified conditions.

National banks and state banks and trust companies once carried DOUBLE LIABILITY on their stock, stockholders being subject to assessment up to the par value of their shares in addition to losing their original investment. In accordance with the Banking Acts of 1933 and 1935, double liability for national bank stock has been ended, and most states have provided similar legislation for state banks and trust companies.

*See* LIMITED COMPANY.

**LIMITED ORDER** Limit order; a buy or sell order placed with a broker for execution at a specified price. Execution is to be effected at the limit or better.

*See* ORDER.

**LIMIT OF TOLERANCE** *See* LIGHT GOLD, TOLERANCE.

Alaska also incorporates companies that carry the designation "LTD"

# DIVISION OF LEGAL SERVICES

## LEGISLATIVE AFFAIRS AGENCY
## STATE OF ALASKA

*(907) 465-3867 or 465-2450*
*FAX (907) 465-2029*
*Mail Stop 3101*

*130 Seward Street, Suite 409*
*Juneau, Alaska 99801-2105*

**MEMORANDUM** March 4, 1994

**SUBJECT:** Sectional summary SSHB 420

**TO:** Representative Gene Therriault
Attn: Wilda

**FROM:** Theresa L. Bannister
Legislative Counsel

You have requested a sectional summary of the above-described bill.

As a preliminary matter, note that a sectional summary of a bill should not be considered an authoritative interpretation of the bill and the bill itself is the best statement of its contents.

Section 1. Contains a new chapter on limited liability companies.

Sec. 10.50.010 states that a limited liability company ("company") may be organized for any lawful purpose.

Sec. 10.50.015 requires a company to comply with other applicable laws.

Sec. 10.50.020 requires a company name to contain certain words or abbreviations. Allows the name to use the name of a city, borough, or village but not to contain certain words or to otherwise imply the company is a municipality. Prohibits a person from adopting a name containing "limited liability company" unless the person is organized under this chapter or is registered as a foreign limited liability company under this chapter.

Sec. 10.50.025 requires a company name to be distinguishable on the records of the Department of Commerce and Economic Development ("department") from certain other names.

Sec. 10.50.030 authorizes certain persons to reserve a company name.

Sec. 10.50.035 establishes the procedure for reserving a company name.

Sec. 10.50.040 authorizes the holder of a reserved name to transfer the name to another person. Establishes how the transfer is accomplished.

Sec. 10.50.045 requires a company to maintain in this state a registered office and a registered agent for the service of process.

Sec. 10.50.050 establishes how a company may change its registered office or agent and how an agent may change the agent's address.

Sec. 10.50.055 establishes when a change of a registered office, a registered agent or the address of a registered agent becomes effective.

Sec. 10.50.060 authorizes a registered agent to resign. Indicates how the agent may resign and when the resignation becomes effective.

Sec. 10.50.065 appoints the commissioner of the department under certain circumstances as the agent of a company for the service of process, notice, or demand. Establishes how a person may serve the commissioner. Directs the commissioner to keep a record of documents served on the commissioner. States that this section does not affect the right to serve process, notice, or demand on a company in another manner permitted by law.

Sec. 10.50.070 authorizes one or more persons to organize a company. Establishes the procedure for organization.

Sec. 10.50.075 identifies what the articles of organization must contain, which includes certain information about any election to continue the company until a certain date or event.

Sec. 10.50.080 determines when a company's organization is effective. Provides that the company's existence terminates if its articles are nonconforming and not cured within the specified time.

Sec. 10.50.085 states that a company's existence continues until specified date or event, except under certain circumstances, if the company has made an election to continue until the certain date or event and the election is stated in the articles of organization. Prohibits revocation of an election unless certain specified persons revoke the election. Allows an election to expressly limit the membership terminations that can cause dissolution.

Sec. 10.50.090 establishes that articles of organization that are file-stamped and marked with the filing date are conclusive evidence that the company is organized.

Sec. 10.50.100 authorizes a company to amend its articles at any time and indicates the procedure for doing so.

Sec. 10.50.105 authorizes a company to restate its articles and establishes the procedure for doing so.

Sec. 10.50.110 declares that the members of a company manage the company, unless an operating agreement names a manager for the company or the chapter provides otherwise. Declares that if an operating agreement authorizes a manager for the company, the manager has the exclusive power to manage the company to the extent of the authorization.

Sec. 10.50.115 requires over one-half of the members to approve before a manager is appointed, removed, or replaced, unless an operating agreement provides otherwise.

Sec. 10.50.120 allows a manager to be other than an individual or a company member, unless a company operating agreement provides otherwise.

Sec. 10.50.125 establishes how long a manager holds office.

Sec. 10.50.130 declares that a member who is not a manager of a company that is managed by a manager does not have a fiduciary duty of a manager to the company or to other members when acting solely as a member, unless an operating agreement provides otherwise.

Sec. 10.50.140 requires the members and the managers to account to the company and hold as trustee for the company certain identified benefits obtained without the described consent, unless an operating agreement provides otherwise.

Sec. 10.50.145 establishes what authorization is required for company affairs, depending on whether the company is managed by its members or by managers.

Sec. 10.50.155 indicates that a person may become a company member if the person acquires a company interest in certain ways.

Sec. 10.50.160 establishes when a person's admission to membership in the company is effective.

Sec. 10.50.165 establishes the conditions for an assignee of a company interest to become a company member.

Sec. 10.50.170 establishes the rights, powers, and liabilities of an assignee who becomes a member.

Sec. 10.50.180 establishes that when an assignee of a member's entire membership interest becomes a member with respect to the assignor's entire interest, the assigning member ceases to be a member, unless otherwise provided in an operating agreement.

Sec. 10.50.185 states that a person's company membership terminates if the person withdraws voluntarily from the company. Authorizes a member to voluntarily terminate a company membership at any time, unless an operating agreement provides otherwise.

Sec. 10.50.190 establishes that, if a company has a definite term or undertaking, the voluntary withdrawal of a member before the end of the term or the accomplishment of the undertaking is a breach of the operating agreement, unless the operating agreement provides otherwise.

Sec. 10.50.195 establishes that a company can recover damages from a member who withdraws wrongfully. Authorizes the company to offset the damages against a distribution owed to the member and to pursue other remedies against the member.

Sec. 10.50.205 states that, except as otherwise provided in an operating agreement for the removal of a member, a person's company membership terminates if the person assigns all of the membership interest and if a majority of the members who have not assigned their interests authorize the removal of the member.

Sec. 10.50.210 states that a person's company membership terminates if the member dies or is declared incompetent by a court, unless otherwise provided in an operating agreement.

Sec. 10.50.215 states that the company membership held by a trust or trustee terminates when the trust terminates and that a company membership held by an estate terminates when the estate's entire company interest is distributed by the estate, unless otherwise provided in writing in an operating agreement or by the written consent of all of the members.

Sec. 10.50.220 states that the company membership of a member that is a separate limited liability company terminates when the member dissolves and begins to wind up, unless otherwise provided in writing in an operating agreement or by the consent of all members. Also states that the membership of a corporate member terminates when the corporation is dissolved and 90 days elapse without reinstatement, unless otherwise provided in writing in an operating agreement or by the consent of all members.

Sec. 10.50.225 identifies other events that terminate a company membership.

Sec. 10.50.240 provides that secs. 10.50.185 - 10.50.225(a)-(b) don't apply to the termination of a membership unless the member is also a company manager, if an election has been made to continue the company until a certain date or event.

Sec. 10.50.250 states that a company member is an agent of the company for the purpose of conducting the company's affairs, except under certain circumstances, including where the articles name a manager for the company. If a manager is named, the manager is an agent of the company for the purpose of conducting its affairs, except in certain circumstances. Establishes when a member's or manager's act binds the company.

Sec. 10.50.255 states that an admission or representation by a company member about the company is evidence against the company, except in certain circumstances, including where the articles name a manager for the company. If a manager is named, an admission or representation by a manager is evidence against the company under certain circumstances, and the admission or representation by a member acting solely as a member is not evidence against the company.

Sec. 10.50.260 indicates when a company is charged with the knowledge of or a notice given to a member or manager.

Sec. 10.50.265 states that a company member is not liable, solely by reason of being a member, for a company liability.

Sec. 10.50.275 authorizes a company to issue company interests for property, services, or a promissory note or other obligation to contribute property or services.

Sec. 10.50.280 states that a member's promise to contribute property or services to the company is enforceable only if the promises is in a writing signed by the member. Makes the promise enforceable even if the member is unable to perform because of death, disability, or other reason, unless otherwise provided by an operating agreement. Requires a company member who has not made the required contribution of property or services to contribute cash equal to the shortfall. States that an assignor of a company interest remains liable for a contribution even if the assignee becomes a member with respect to the assigned interest, unless otherwise provided in an operating agreement.

Sec. 10.50.285 prohibits the compromise of a company member's obligation to make a contribution, unless otherwise provided in an operating agreement.

Sec. 10.50.300 declares that, unless otherwise provided in writing in an operating agreement, members are to be repaid their contributions to capital and share equally in the assets of the company after liabilities are satisfied.

Sec. 10.50.305 requires interim distributions to members to be made according to an operating agreement, if an operating agreement provides for the distributions. The operating agreement may authorize different interim distributions for different classes of members.

Sec. 10.50.310 requires interim distributions to members to be equal, unless an operating agreement provides for the distribution.

Sec. 10.50.315 indicates at what times a company member is entitled to an interim distribution.

Sec. 10.50.320 directs a company to distribute to a terminated member any distribution that the member was entitled to receive before the termination, except where the member is removed or the termination does not cause dissolution. In addition, directs the company to distribute to the terminating member the amount of the member's company interest. Establishes the amount of the interest if a company operating agreement does not establish the amount or how to calculate the amount. If an election has been made to continue the company until a certain date or event, the distribution provisions don't apply unless the member is also a company manager.

Sec. 10.50.325 prohibits a member from demanding and receiving a distribution in other than cash, unless otherwise provided in an operating agreement. Prohibits a company from compelling a company member to accept assets in a form other than cash under certain circumstances.

Sec. 10.50.330 states that a company member entitled to receive a distribution becomes a creditor of the company and is entitled to all available creditor remedies.

Sec. 10.50.350 states that property transferred to or otherwise acquired by a company is the property of the company and not of the members individually. States that a company may acquire, hold, and convey property in the name of the company. States that when the company acquires an interest in real property the company holds the title and not the members individually.

Sec. 10.50.355 indicates how a company's property may be transferred, depending on whose name the property is held in and whether the company has a manager.

Sec. 10.50.360 authorizes a company to recover its transferred property if the company proves certain facts, unless certain circumstances exist.

Sec. 10.50.365 authorizes, under certain circumstances, the transfer, free of company or member claims, of company property held in the name of a person other than the company.

Sec. 10.50.370 states that a company interest is personal property.

Sec. 10.50.375 authorizes the assignment of a company interest. States that an assignment entitles the assignee to receive, to the extent assigned, only the distributions to which the assignor is entitled. States that an assignment does not dissolve the company or entitle the assignee to participate in the management and affairs of the company, to become a member, or to exercise member rights. The assignor continues to be a member unless the assignee becomes a member with respect to the interest. Allows a written operating agreement to vary the terms of the section. States that certain activities of a member do not amount to assignments and do not terminate the membership or the rights and powers of the member, unless otherwise provided in an operating agreement.

Sec. 10.50.380 authorizes a court to charge a member's company interest for payment of a judgment creditor against the member. Indicates the effect of the charge.

Sec. 10.50.385 states that in the case of a member's death or incompetency the member's legal representative has the rights of an assignee of the member's company interest.

Sec. 10.50.390 states that if a member (not an individual) terminates or is dissolved, the member's legal representative or successor has the rights of an assignee of the member's interest.

Sec. 10.50.400 identifies the events that dissolve a company and require winding up of its affairs.

Sec. 10.50.405 authorizes the superior court to order a company's dissolution under certain circumstances.

Sec. 10.50.410 indicates who may wind up a company's affairs, unless otherwise provided in an operating agreement.

Sec. 10.50.415 identifies the acts that a person winding up a company's affairs may perform.

Sec. 10.50.420 establishes when, how, and under what circumstances a member or manager can bind a company that is dissolved and winding up its affairs.

Sec. 10.50.425 establishes the manner and priority for the distribution of a company's assets upon its winding up.

Sec. 10.50.430 allows a company to file articles of dissolution with the department after it dissolves. Describes what the articles must state.

Sec. 10.50.435 establishes how a company after its dissolution may dispose of the known claims against it. Declares under what conditions a known claim against the company is barred.

Sec. 10.50.440 establishes how a company after its dissolution may dispose of unknown claims against it. Declares that unknown claims are barred unless the claimant takes certain action within three years after the later of certain events. Authorizes the claimant to enforce a claim against the company's undistributed assets or against company members under certain circumstances; limits a member's total liability.

Sec. 10.50.500 authorizes a company to merge or consolidate with or into a domestic or foreign limited liability company, subject to the law applicable to the other company and unless otherwise provided in an operating agreement.

Sec. 10.50.505 authorizes the rights of, or interests in, a party to a merger or consolidation to be exchanged for or converted into cash, property, obligations, rights or other interests of, or interests in, the surviving or resulting company.

Sec. 10.50.510 establishes what member or other approval is required before a company may approve a proposed merger or consolidation. Authorizes a party to a merger or consolidation to abandon the merger or consolidation as provided in the merger or consolidation agreement.

Sec. 10.50.515 requires the company surviving or resulting from a merger or consolidation under this chapter to file articles of merger or consolidation with the department. The articles must be signed by each company that is a party to the merger or consolidation.

Sec. 10.50.520 describes what the articles of merger or consolidation must state.

Sec. 10.50.525 requires articles of merger or consolidation to be signed by a company that is a party to the merger or consolidation.

Sec. 10.50.530 states that articles of merger or consolidation constitute articles of dissolution for a company that is not the surviving or resulting company in a merger or consolidation.

Sec. 10.50.535 indicates when a merger or consolidation takes effect.

Sec. 10.50.540 states that a merger or consolidation agreement may amend a company's operating agreement or adopt a new operating agreement for the company, if the company is the surviving or resulting company in a merger or consolidation. Authorizes an approved merger or consolidation agreement to provide

that a company's operating agreement will be the operating agreement of the company that is the surviving or resulting company. States when an amendment to an operating agreement or the adoption of a new operating agreement under this section is effective. States that this section does not limit the accomplishment of a merger or other matter covered by the section by other means allowed under an operating agreement, another agreement, or another law.

Sec. 10.50.545 describes the general effects of merger or consolidation. These include the termination of companies that are not the surviving or resulting companies and the transfer of the applicable rights, privileges, immunities, powers, franchises, restrictions, disabilities, and duties of the participating companies to the surviving or resulting company.

Sec. 10.50.550 describes the effects of merger or consolidation on the property of the participating companies.

Sec. 10.50.555 describes the effect of merger or consolidation on the liabilities of the participating companies.

Sec. 10.50.560 declares that creditor rights and liens on the property of a company that is a party to a merger or consolidation are not impaired by the merger or consolidation.

Sec. 10.50.565 states that upon a merger or consolidation a company's interests that are to be converted or exchanged into other property under the merger or consolidation agreement are converted as provided by the merger or consolidation agreement. States that the former holders of interests so converted have the rights provided in the merger or consolidation agreement or otherwise provided by law.

Sec. 10.50.590 defines "limited liability company" for secs. 10.50.500 - 10.50.590.

Sec. 10.50.600 states that, subject to this state's constitution, a foreign company's organization, internal affairs, and the liability and authority of its managers and members are governed by the law of the jurisdiction where the company is organized. Prohibits the department from denying registration to a foreign company because of differences between the law of this state and the jurisdiction where the foreign company is organized.

Sec. 10.50.605 requires a foreign company to register with the department before conducting affairs in this state. The foreign company is required to deliver an application for registration to the department.

Sec. 10.50.610 requires the registration application to be signed by a person who is authorized to sign by the law of the jurisdiction where the company was organized.

Sec. 10.50.615 describes what the registration application must state.

Sec. 10.50.620 prohibits the department from filing the registration of a foreign company unless the company name satisfies certain requirements.

Sec. 10.50.625 authorizes a foreign company to amend its registration by filing articles of amendment with the department.

Sec. 10.50.630 establishes what the articles of amendment must state. Authorizes the amendment of the application in any way as long as the amended application only contains provisions that are otherwise allowed by this chapter to be contained in an application for registration at the time of the amendment.

Sec. 10.50.635 requires a foreign company to maintain an agent in this state for the service of process. Indicates which persons qualify to be an agent.

Sec. 10.50.640 establishes the procedure for changing a foreign company's registered agent or the agent's address.

Sec. 10.50.645 provides guidelines for when the change of registered agent or agent address for a foreign company becomes effective.

Sec. 10.50.650 describes how a registered agent of a foreign company may resign as the registered agent. Requires the department to mail a copy of the resignation to the company. Indicates when the resignation becomes effective.

Sec. 10.50.655 authorizes a foreign company to cancel its registration by filing an application for cancellation with the department.

Sec. 10.50.660 describes what an application for cancellation must state.

Sec. 10.50.665 describes the form, manner, and execution of an application for cancellation of the registration of a foreign company.

Sec. 10.50.670 states that the cancellation of a registration does not terminate the authority of the department to accept service of process on the foreign company with respect to causes of action arising out of the company's conduct of affairs in this state.

Sec. 10.50.675 prohibits an unregistered foreign company conducting affairs in this state from maintaining a action or other proceeding in a court of this state until it has registered. States that the failure to register does not impair the validity of the company's contracts or acts, affect the rights of another party to a company contract

to maintain an action or other proceeding on the contract, or prevent the company from defending an action or other proceeding in a court of this state.

Sec. 10.50.680 states that a foreign company that conducts affairs in the state without being registered appoints the department as its agent for service of process with respect to a cause of action arising out of conducting affairs in this state.

Sec. 10.50.685 provides for service on the commissioner in the manner provided under sec. 10.50.065(b) and under certain circumstances. Requires the commissioner to keep a record of the processes, notices, and demands served on the commissioner. States that this section does not affect the right to make service in another manner permitted by law.

Sec. 10.50.690 states that a foreign company conducting affairs in this state without registration is liable to the department for certain fees and penalties.

Sec. 10.50.700 states that a foreign company that conducts affairs in this state without registration is subject to a civil penalty and authorizes the attorney general to recover the penalty.

Sec. 10.50.710 authorizes a court, under certain circumstances, to issue an injunction against a foreign company conducting affairs in the state in violation of this chapter. Indicates how long the injunction may continue.

Sec. 10.50.715 states that a member or manager of a foreign company is not liable for the debts and obligations of the company solely because the company conducts affairs in this state without registration.

Sec. 10.50.720 lists the transactions that do not constitute conducting affairs for a foreign company in this state.

Sec. 10.50.730 authorizes a court action to be brought by or against the company in the name of the company.

Sec. 10.50.735 prohibits a person from bringing a court action on behalf of a company in the name of the company unless the requirements of the section are met. Sets out these requirements.

Sec. 10.50.740 prohibits a company from asserting the lack of authority of a company member or manager to bring court action on behalf of a company as a defense to the action or as a basis for bringing a subsequent action on the same cause of action.

Sec. 10.50.800 declares that, unless an operating agreement provides otherwise, a company member or manager is not liable to the company or the company members

for damages or other relief for an act or a failure to act on behalf of the company unless the act or failure to act amounts to gross negligence or wilful misconduct. Provides that an operating agreement may limit or eliminate the personal liability of a company member or manager for breaches of duty under secs. 10.50.130 - 10.50.140 or subsec. (a).

Sec. 10.50.805 authorizes a company to use an operating agreement to authorize the company to indemnify a company member or manager for judgments, settlements, penalties, fines, or expenses incurred by the person under certain circumstances.

Sec. 10.50.810 states that a company member is not a proper party to a proceeding by or against the company just for being a member, except in certain circumstances.

Sec. 10.50.820 states that a company operating agreement may authorize a company to issue a certificate as evidence of a company interest and to authorize and provide for the assignment or transfer of the interest represented by the certificate.

Sec. 10.50.830 establishes how a document is to be delivered to or filed with the department.

Sec. 10.50.840 establishes the department's procedure and criteria for filing documents. Prohibits the department from filing a document if the section's requirements are not met.

Sec. 10.50.850 establishes who is to sign documents filed with the department and how the documents are to be signed. Authorizes a person to sign as an attorney-in-fact.

Sec. 10.50.855 establishes a procedure for obtaining a court order to direct the department to file certain documents.

Sec. 10.50.860 directs the department to charge fees for filing and other services it provides under the chapter.

Sec. 10.50.870 requires a company, unless otherwise provided in writing in an operating agreement, to maintain certain described records at its principal place of business.

Sec. 10.50.875 authorizes a company member to inspect and copy the company's records under certain conditions.

Sec. 10.50.880 requires certain persons to disclose to a member under certain circumstances true and full information of all matters that affect the members of a company.

Sec. 10.50.890 states that a company's failure to maintain a required record or information does not make a member or manager liable for the company's obligations.

Sec. 10.50.900 authorizes the department to adopt regulations to implement the chapter, in addition to any regulations the department is required to adopt under this chapter.

Sec. 10.50.910 authorizes a company organized and existing under this chapter to conduct its affairs and exercise the powers granted by this chapter in another jurisdiction, subject to the laws of that jurisdiction.

Sec. 10.50.920 declares the chapter's support of the principle of freedom of contract and enforceability of operating agreements. States that the rule that statutes in derogation of the common law are to be strictly construed does not apply to the chapter.

Sec. 10.50.990 defines terms for the new chapter.

Sec. 10.50.995 gives the new chapter a short title.

Section 2. Amends the for-profit corporations code to prevent that code from prohibiting a limited liability company from using "limited" in its name.

Section 3. Describes how a section of the new chapter amends the Alaska Rules of Civil Procedure.

Section 4. Makes the Act effective January 1, 1995.

If I may be of further assistance, please advise.

TLB:gc
94-168.glc

FORTIER & MIKKO
A PROFESSIONAL CORPORATION
Attorneys at Law

DENALI TOWERS NORTH
2550 DENALI STREET
SUITE 604
ANCHORAGE, ALASKA 99503

TELEPHONE (907) 277-4222
FAX LINE (907) 277-4221

SAMUEL J. FORTIER
DAGMAR C. MIKKO
STEVEN B. SUMIDA*
JOHN L. HOFFER, JR.**

*Also admitted in Wyoming
**Also admitted in Washington

March 1, 1994

Representative Bill Hudson, Chairman
House Committee on Labor and Commerce
State Capital Rm 108
Juneau, Alaska 99801-1182

VIA FAX
465-6790

Re: Sponsor Substitute for House Bill 420

Dear Representative Hudson:

As an attorney in the State of Alaska, I am very eager to have the state pass legislation authorizing limited liability companies, as has been done in virtually all other states in the country. Accordingly, I urge that your committee promptly schedule a hearing on the sponsor substitute for House Bill 420.

Your assistance in ushering this bill through your committee would be deeply appreciated.

Very truly yours,

FORTIER & MIKKO, P.C.

By: _____
John L. Hoffer, Jr.

JLH:mv JLH\Hudson.ltr

# Partnership, Corporation Aren't Only Ways to Start Out

## Forming as a Limited Liability Company Offers Best of Both Worlds

By JEFFREY A. TANNENBAUM
*Staff Reporter of THE WALL STREET JOURNAL*

Robert H. Kane's start-up enterprise is a mouthful: Octagon Communications Limited Liability Co.

The name doesn't exactly have a ring to it. It's rather awkward on stationery and business cards. It even fails to convey the company's intended business: investments in rural cellular-telephone companies.

But loud and clear, the name conveys something else: a new form of ownership that Mr. Kane and his seven partners expect will serve them well. Their enterprise—to be based in Denver—is neither a traditional partnership nor a traditional corporation. Rather, under Colorado law, it is a "limited liability company," or LLC.

### Growing Interest

Mr. Kane and his partners expect to enjoy the best of both worlds: the tax advantages of a partnership and the legal safeguards of a corporation. Yet they face none of the drawbacks associated with forming a so-called subchapter-S corporation, which also is taxed much like a partnership. For example, S corporations can't have corporate shareholders, but LLCs can. "If some corporation ever wants to offer me jillions of dollars for my interest, I'll be able to sell it," Mr. Kane says.

Not yet worth jillions, Octagon doesn't even have an office. But it is in the forefront of a movement toward the LLC as a form of ownership for small U.S. businesses and joint ventures. "Interest in the LLC concept is growing remarkably fast," says John R. Maxfield, a Denver lawyer who helped write the LLC law there.

Fast, anyway, by the slow-paced standards of lawmaking. In 1977, Wyoming became the first state to authorize LLCs, but it took until 1988 for the Internal Revenue Service to confirm that the new Wyoming entities would be treated as partnerships for federal tax purposes.

To date, only five other states—Colorado, Florida, Kansas, Virginia and, most recently, Utah—have followed Wyoming in authorizing their own LLCs, according to an American Bar Association survey. But lawyers in many other states report growing interest because of the IRS ruling. Two ABA panels are studying the topic, as is the National Conference of Commissioners on Uniform State Laws, a group allied with the ABA. Meantime, moves are afoot to introduce LLC statutes in Arizona, Illinois, Maryland, Michigan, Nevada, Ohio, Oklahoma and Texas, the ABA survey found.

"I'm stunned by the amount of excitement generated by these entities," says Barbara C. Spudis, a Chicago attorney and the head of one ABA panel on LLCs.

### Flexibility of a Partnership

One appeal of LLCs is that, as with partnerships, any income flows through untaxed to the individual owners. Such owners don't avoid personal taxes, but they do avoid corporate taxes. Regular corporations face higher maximum taxes in the first place. And if the corporations pay dividends, owners are taxed again.

Of course, S corporations avoid double taxation—but they don't enjoy all the advantages of partnerships when it comes to juggling income and deductions. For example, the 20%-owner of an S corporation normally must pay taxes on 20% of any income. By contrast, partnership members are free to divvy up any income and tax liability as they see fit. Thus, equal partners might change the allocations of profit or loss year to year to fit their individual tax needs. LLCs offer the same freedom.

With LLCs, as with regular corporations, only the company's assets, and not the owners' personal assets, are at risk in business-related lawsuits. In partnerships, so-called limited partners enjoy such protection, but general partners don't. And limited partners face restrictions on how active they can be in the business. LLCs are designed to protect all partners while imposing no limits on their activity.

Not surprisingly, lawyers in a few states say LLCs are an easy sell. Since Colorado's LLC statute went into effect in April 1990, 250 LLCs have been organized there, an official says. Forming an LLC usually costs $1,000 to $5,000 in attorney and filing fees, depending on complexity, says Mr. Maxfield, the Denver lawyer.

But some state programs have drawbacks. Florida LLCs are exempt from federal corporate taxes but subject to the state's 5.5% corporate-income tax. Since Florida has no personal income tax affecting partnership income, "that 5.5% is enough to scare people off," says Jose M. Sariego, a Miami lawyer.

Moreover, the IRS has yet to give its imprimatur to any state LLC program except Wyoming's, though a few LLCs elsewhere have gotten favorable private-letter rulings. And lawyers say it's unclear how enterprises treated as LLCs in their home states will be treated in states without LLC laws. Of the states without LLCs, Indiana alone explicitly recognizes LLCs organized elsewhere. "There has been no litigation on LLCs," says Robert R. Keatinge, a Colorado lawyer who heads the other ABA panel on LLCs. "And nobody wants to be the test case."

### Benefit for Foreigners

Still, proponents say the LLC raises little risk for enterprises operating only in their home state or outside the U.S. And it's ideal for foreign investors—normally barred from S corporations.

LLCs don't limit the number or type of owners, as S corporations do, except for a two-owner minimum. But because of other restrictions, only closely held enterprises are suited to be LLCs. For example, if any owner leaves, the others must all formally agree to keep the enterprise going. "If you have 200 members, it's hard to get everybody to sign off on anything," Mr. Keatinge says.

But even closely held companies face uncertainties on a number of technical and procedural issues, such as whether the conversion of a partnership into an LLC amounts to a "termination" under tax law, which might increase tax liability. IRS rulings are still awaited. In the meantime, warns Ms. Spudis, the Chicago lawyer, many LLC investors are entering uncharted territory.

ALASKA SOCIETY OF CPA'S
341 W. TUDOR #105
ANCHORAGE, AK 99503
(907)562-4334
800-478-4334
FAX (907)562-4025

FEB 25 1994

February 22, 1994

House Judiciary Committee
Alaska State Legislature
State Capitol
Juneau, AK 99801-1182

Re: Limited Liability Company Bill

Dear Sirs:

On February 17, 1994 the Board of Directors of the Alaska Society of Certified Public Accountants unanimously voted to endorse the Sponsor Substitute for House Bill 420, the introduction of legislation allowing businesses to form and operate as a Limited Liability Company in the State of Alaska.

The membership of the Alaska Society of Certified Public Accountants is State wide. The Board is representative of the membership.

In order for the State to continue to grow through ne[illegible]e, it is important that there is flexibility in the type [illegible]y a business can form. The State should be able to offer the same type of entities as any other state offers (right now there over 30 States that allow Limited Liability Companies).

We look forward to the passage of this law in a swift and expedient manner. Businesses that want to operate as a Limited Liability Company may not wait for the legislature, and will seek an operating "home" in some other state.

Very truly yours,

William D. Arnold
President

cc: Wilda Whitaker

# HOUSE COMMITTEE REPORT

(7)

Date Referred: February 24, 1994 FURTHER REFERRALS: Judiciary
State Affairs

Date of Committee Action: 3/08/94

The LABOR AND COMMERCE Committee considered: SSHB 420

SPONSOR SUBSTITUTE FOR HOUSE BILL NO. 420 LIMITED LIABILITY COMPANIES

"An Act relating to limited liability companies; amending Alaska Rules of Civil Procedure 20 and 24; and providing for an effective date."

RECOMMENDATIONS: [ ] the same title
be replaced with _____ [ ] a new title

[ ] have attached amendments(s)

[ ] do pass

[ ] do not pass

[ ] no recommendations

[X] individual recommendations

[ ] additional referral to the _____ Committee

ADOPTS: _____ letter of Intent

ATTACHES NEW FISCAL NOTE(s): (Dept) APPROVES PREVIOUS: (Dept/Date)

[ ] fiscal impact _____ [ ] fiscal note(s) _____

[X] zero fiscal note Commerce [ ] zero fiscal note(s) _____

| SIGNING DO PASS | DP | OTHER RECOMMENDATIONS | DNP | NR | AM |
|---|---|---|---|---|---|
| Gloria Hild | ✓ | W.K. Williams | | ✓ | |
| | | Joe Sutton | | ✓ | |
| | | Bill Hudson | | ✓ | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |

Bill Hudson
SIGNATURE

HARTIG, RHODES, NORMAN, MAHONEY & EDWARDS
A PROFESSIONAL CORPORATION
ATTORNEYS AT LAW
717 K STREET
ANCHORAGE, ALASKA 99501-3397
TELEPHONE: (907) 276-1592
TELECOPIER: (907) 277-4352

ROBERT L. HARTIG (1928-1980)

PETER B. BRAUTIGAM
CHERYL BROOKING
G. KENT EDWARDS
ROBERT B. FLINT
SEAN HALLORAN
LAWRENCE L. HARTIG
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JAMES D. RHODES
L. ANDREW ROBINSON
BONNIE J. STRATTON
MICHAEL D. WHITE

PALMER OFFICE
L. ANDREW ROBINSON
808 S. BAILEY STREET
SUITE 101
PALMER, ALASKA 99645
TELEPHONE: (907) 745-5031
TELECOPIER: (907) 745-6067

RECIPROCAL RELATIONSHIP
GRUENING & SPITZFADEN
217 SECOND STREET, SUITE 204
JUNEAU, ALASKA 99801
TELEPHONE (907) 586-8110

REPLY TO:
Anchorage

March 4, 1994

Representative Bill Hudson
Chairman
House Committee on Labor and Commerce
State Capital, Room 108
Juneau, AK 99801-1182

Re: House Bill 420

Dear Representative Hudson:

This letter is sent in regard to the Sponsor Substitute for House Bill 420 which deals with a new form of business entity, limited liability companies. I am very much in favor of this bill and would hope that there would be a hearing scheduled soon. Having a limited liability business entity would provide Alaskan business investors with partnership tax treatment along with corporate-type limited liability.

Sincerely,

HARTIG, RHODES, NORMAN,
MAHONEY & EDWARDS

By: Peter B. Brautigam

PBB/kp
cc: Brian Porter
Joe Green
Eldon Mulder
kp\docs\579\hudson.ltr

Received
MAR 08 1994

HB
439

# FISCAL NOTE

STATE OF ALASKA
1994 LEGISLATIVE SESSION

BILL NO. HB 439

Revision Date: February 1, 1994
Title: "An Act enacting the Uniform Fraudulent Transfer Act."
Sponsor: Representative Porter
Requestor: Representative Porter

Department Affected: Department of Law
BRU: Legal Services
Component: Operations

COMPONENT SERIAL NO. 0093

EXPENDITURES/REVENUES:

| OPERATING | FY 95 | FY 96 | FY 97 | FY 98 | FY 99 | FY 00 |
|---|---|---|---|---|---|---|
| PERSONAL | | | | | | |
| TRAVEL | | | | | | |
| CONTRACTUAL | | | | | | |
| SUPPLIES | | | | | | |
| EQUIPMENT | | | | | | |
| LAND & | | | | | | |
| GRANTS, CLAIMS | | | | | | |
| MISCELLANEOUS | | | | | | |
| TOTAL OPERATING | -0- | -0- | -0- | -0- | -0- | -0- |
| CAPITAL | | | | | | |
| REVENUE | | | | | | |
| FUNDING: | | | | | | |
| 1002 Federal | | | | - | | |
| 1003 GF Match | | | | | | |
| 1004 GF | | | | | | |
| 1005 GF/Program | | | | | | |
| 1006 GF/MHTIA | | | | | | |
| OTHER | | | | | | |
| TOTAL | -0- | -0- | -0- | -0- | -0- | -0- |
| POSITIONS: | | | | | | |
| FULL-TIME | -0- | -0- | -0- | -0- | -0- | -0- |
| PART-TIME | | | | | | |
| TEMPORARY | | | | | | |

Estimate of current year (FY94) impact: -0-

ANALYSIS: (Attach a separate page if necessary.)
Please see the attached analysis.

Prepared by: Richard L. Pegues, Director
Division: Administrative Services Division
Phone: 465-3672
Date: February 1, 1994

Approved by Commissioner: Richard L. Pegues /FOR/ Bruce M. Botelho, Attorney General
Agency: Department of Law
Date: February 1, 1994

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Fiscal Notes

FISCAL NOTE

STATE OF ALASKA
1994 LEGISLATIVE SESSION

BILL NO. _____

ANALYSIS CONTINUATION:

This bill amends AS 34 to adopt the Uniform Fraudulent Transfer Act for Alaska. The uniform act is recommended by the National Conference of Commissioners on Uniform State Laws (NCCUSL). Its purpose is to protect creditors against the fraudulent transfer of assets and fraudulent obligations that would otherwise work to defeat a creditor's interests. The proposed act includes personal as well as real property. Current law, which was adopted in the 1940's and is based on even older law, only addresses real property. Because the bill is a Uniform Act based on the NCCUSL model, it will conform to the requirements of most of the other state's thus making its provisions (and protections) available for many interstate transactions. The bill deals primarily with private transactions. It will not have a fiscal impact for the Department of Law.

# Alaska State Legislature

## House of Representatives

House Judiciary Committee

P. O. Box V
State Capitol
Juneau, Alaska 99811
(907) 465-4990
(907) 465-4712

**SPONSOR STATEMENT**

**HB 439 UNIFORM FAUDULENT TRANSFER ACT**

Obligation to a financial debt is reinforced by law. Or is it? If a person acquired debt should (s)he be able to manipulate the assets so that creditors will be deprived of their value when (s)he defaults on the debt? The Uniform Fraudulent Transfer Act (UFTA) works as a *deterrent*, preventing such transgressions against obligations incurred. This Act provides creditors with a *remedy* when debtors transfer or hide assets that would otherwise be available to satisfy legitimate debts.

Current Alaska law in this area was adopted in 1949 from the state of Oregon and has received little legislative attention. Nevertheless, many changes in both state and federal law, particularly in the area of bankruptcy, and relationships between creditors and debtors have become more complex. In fact, Alaska law provides that a conveyance of real or personal property will be void if it was made "with the *intent* to hinder, delay or defraud creditors." AS 34.40.010. The existence of this fraudulent intent is a question of fact and the burden of proof is upon the plaintiff (Summers v. Hagen __ P.2d __, No. 3961, May 28, 1993). This burden of proof can be extremely hard to prove.

UFTA would eliminate the present Alaskan necessity of finding actual intent by a property transferor to hinder, delay or defraud a creditor in many situtations where the transferor is obviously transferring assets solely to keep them out of the reach of the transferor's creditors. This Act renders a transfer made or obligation incurred without *adequate consideration* to be constructively fraudulent. UFTA sets out numerous non-exclusive factors to be considered by the court when determining if the debtor had "actual intent." The transferee's "good faith" defense is irrelevant. Consequently, UFTA defines insolvency and establishes a new category of fraudulent transfers, namely, a preferential transfer by an insolvent "insider" (i.e., relative or a person in control of the debtor) to a creditor who had reasonable cause to believe the debtor to be insolvent.

Thirty-two (32) states have adopted UFTA into their laws. Uniformity has become not only a question of law between states, but also between state and federal law. Without *uniformity*, credit becomes less available, and the credit mechanism is less reliable. The Uniform Fraudulent Transfer Act takes into account the considerable development in both law and practice in creditor-debtor relationships.

# FISCAL NOTE

**STATE OF ALASKA**
**1994 LEGISLATIVE SESSION**

**BILL NO.** HB439

Revision Date: 2/28/94
Title: "Uniform Fraudulent Transfer Act"

Sponsor: House Judiciary Committee
Requestor: House Labor and Commerce

Department Affected: Commerce and Economic Development
BRU: Banking & Corporations
Component: Banking

**COMPONENT SERIAL NO.**

Expenditures/Revenues:

| OPERATING EXPENDITURES | FY 95 | FY 96 | FY 97 | FY 98 | FY 99 | FY 00 |
|---|---|---|---|---|---|---|
| PERSONAL SERVICES | 0 | 0 | 0 | 0 | 0 | 0 |
| TRAVEL | 0 | 0 | 0 | 0 | 0 | 0 |
| CONTRACTUAL | 0 | 0 | 0 | 0 | 0 | 0 |
| SUPPLIES | 0 | 0 | 0 | 0 | 0 | 0 |
| EQUIPMENT | 0 | 0 | 0 | 0 | 0 | 0 |
| LAND & STRUCTURES | 0 | 0 | 0 | 0 | 0 | 0 |
| GRANTS, CLAIMS | 0 | 0 | 0 | 0 | 0 | 0 |
| MISCELLANEOUS | 0 | 0 | 0 | 0 | 0 | 0 |
| TOTAL OPERATING | 0 | 0 | 0 | 0 | 0 | 0 |
| CAPITAL EXPENDITURES | 0 | 0 | 0 | 0 | 0 | 0 |
| CHANGE IN REVENUES ( ) | 0 | 0 | 0 | 0 | 0 | 0 |
| FUND SOURCE | | | | | | |
| 1002 Federal Receipts | 0 | 0 | 0 | 0 | 0 | 0 |
| 1003 GF Match | 0 | 0 | 0 | 0 | 0 | 0 |
| 1004 GF | 0 | 0 | 0 | 0 | 0 | 0 |
| 1005 GF/Program Receipts | 0 | 0 | 0 | 0 | 0 | 0 |
| 1006 GF/MHTIA | 0 | 0 | 0 | 0 | 0 | 0 |
| Other | 0 | 0 | 0 | 0 | 0 | 0 |
| TOTAL | 0 | 0 | 0 | 0 | 0 | 0 |

Estimate of current year (FY 94) cost: $ 0

| POSITIONS | | | | | | |
|---|---|---|---|---|---|---|
| FULL-TIME | 0 | 0 | 0 | 0 | 0 | 0 |
| PART-TIME | 0 | 0 | 0 | 0 | 0 | 0 |
| TEMPORARY | 0 | 0 | 0 | 0 | 0 | 0 |

ANALYSIS: (Attach a separate page if necessary.)

Prepared by: Larry Carroll
Division: Division of Banking and Securities
Phone:
Date:

Approved by Commissioner: Paul Fuhs
Agency: Commerce and Economic Development
Date: 2/28/94

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A Few Facts About

THE UNIFORM FRAUDULENT TRANSFER ACT

PURPOSE: Providing a creditor with the capacity to procure assets a debtor has transferred to another person to keep them from being used to satisfy the debt.

ORIGIN: The Uniform Fraudulent Transfer Act, completed by the Uniform Law Commissioners in 1984, revises the Uniform Fraudulent Conveyance Act of 1918.

ENDORSED BY: American Bar Association

STATE ADOPTIONS:

30

| | | |
|---|---|---|
| Alabama | Maine | Ohio |
| Arizona | Minnesota | Oklahoma |
| Arkansas | Missouri | Oregon |
| California | Montana | Rhode Island |
| Colorado | Nebraska | South Dakota |
| Connecticut | Nevada | Texas |
| Florida | New Hampshire | Utah |
| Hawaii | New Jersey | Washington |
| Idaho | New Mexico | West Virginia |
| Illinois | North Dakota | Wisconsin |

1993 INTRODUCTIONS: Virginia

For any further information regarding the Uniform Fraudulent Transfer Act, please contact John McCabe or Katie Robinson at 312-915-0195.

(4/15/93)

BACKUP

# THE UNIFORM FRAUDULENT TRANSFER ACT

by

FRED H. MILLER
Professor of Law at the University of Oklahoma

## Section by Section Analysis of the Act

Section 1 contains definitions. Section 2 also contains the definition of "insolvent," and Section 3 the definition of "value." The definition of "asset" in Section 2(2), together with the latter definitions of "insolvent" and "value," in a general sense formulate the core concept of the act: the transfer of an asset (or incurring an obligation) for inadequate value by an insolvent debtor or one rendered insolvent by the transaction is a fraudulent transfer. Subsection 3(B) is worth particular note in this respect because it overrules for state law the controversial holding in Durrett v. Washington Nat. Ins. Co., 621 F.2d 201 (5th Cir. 1980), that a regularly conducted mortgage foreclosure that produces a price "too low" may be avoided as a fraudulent conveyance. By clouding property titles the Durrett rule virtually is a self-fulfilling prophecy.

Section 4 Subsection a(1) states the basic rule of the act: a transfer made or an obligation incurred with actual intent to hinder, delay or defraud creditors is actionable by creditors. How does a creditor prove the debtor's actual intent? Subsection b sets out "badges of fraud" if several of these appear it is strong evidence. Subsection a(2), on the other hand, sets out two cases where the law decrees the intent exists if the facts are as stated.

Section 5 states two further cases where the law decrees the transaction is fraudulent, but only as to present creditors and not also as to creditors arising later as is the case for transfers covered by Section 5.

Section 6 defines when a transaction occurs. It occurs when it can prejudice the rights of third parties, and not when it actually occurs between the parties to it. For example, a creditor does not need this act to set aside a fraudulent security interest that is never filed; the creditor can defeat that interest under the Uniform Commercial Code. Subsection 5 of this Section also states the time when an obligation is incurred.

Section 7 describes the remedies a creditor has to attack and avoid a fraudulent transfer or obligation.

Section 8, however, protects a good faith purchaser for reasonably equivalent value who did not share in the debtor's fraudulent purpose and subsequent good faith transferees for value who are sufficiently remote. Subsection (d) also gives a good faith transferee or obligee against whom the transaction can be avoided protection for any value given.

Subsection (e) is important as protecting lease terminations and security interest enforcement against "Durrett type" attacks, and Subsection (f) allows "workouts" and the like to occur.

Section 9 prescribes statutes of limitation specifically for the act.

Section 10 states the act is supplemented by other law and Section 11 specifies that in interpreting the act, precedent from other states that have enacted it should be used to maintain uniformity.

Section 12 provides the title.

Section 13 repeals the current statutes on the subject, including any old predecessor versions of this act.

# WHY STATES SHOULD ADOPT
# THE UNIFORM FRAUDULENT TRANSFER ACT

Are we only as good as the extent to which we honor our obligations? Many would argue for this proposition. And when our obligations are financial, the argument is reinforced by law. It is to this proposition that the Uniform Fraudulent Transfer Act is addressed. If we have acquired debt we should not be able to manipulate our assets so that creditors will be deprived of their value when we default on our debt. We should not be able to plan an artificial insolvency by transferring assets to others against the interests of our creditors.

The Uniform Fraudulent Transfer Act works as a deterrent, preventing such transgressions against obligations incurred, and provides creditors with a remedy when debtors transfer or hide assets that would otherwise be available to satisfy legitimate debts.

While the issue of obligation is preeminent, the economic issue is no less important. Credit is essential to the economic life of this country. Consumer credit, commercial credit, secured and unsecured credit enter into our lives, everyday. Credit remains available so long as those who extend it are given certain assurances about their rights at default. The Uniform Fraudulent Transfer Act provides assurances to creditors that help make credit available to all of us.

This economic issue leads directly to the issue of uniformity. The availability and the health of the credit mechanism require national standards. The principles of the old Uniform Fraudulent Conveyance Act became applicable to every person in every state because it was incorporated into the Federal Bankruptcy Act. Much of what is in the newer Fraudulent Transfer Act duplicates the Bankruptcy Reform Act of 1978. Uniformity has become not only a question of law between states, but also between state and federal law. Without uniformity, credit becomes less available, and the credit mechanism is less reliable. To avoid confusion and expense, the same rules must apply throughout the country. Public expectations are the same in every state and jurisdiction.

Associated with the issue of uniformity is the issue of modernity. The original Fraudulent Conveyance Act, which the Fraudulent Transfer Act replaces, was promulgated in 1918. Changes in federal bankruptcy law, in creditor-debtor relations in general, even in the rules governing the conduct of lawyers, make it clear that a modernization is overdue. The Uniform Fraudulent Transfers Act answers that immediate need.

# UNIFORM FRAUDULENT TRANSFER ACT

When we say a person "owns" something, we tend to think in all or nothing terms. Whatever a person owns is at that person's disposal - to sell, to give, to abandon, or to pledge as security for a debt. But relationships between people over property are never so simple or so unqualified. A creditor-debtor relationship, for example, may materially change an owner's power over the property owned. A mortgage, clearly, restricts what an owner may do with mortgaged real estate. The creditor has legally protected rights in the real estate securing the debt. Under Article 9 of the Uniform Commercial Code, secured creditors, also, obtain rights in collateral that are protected.

A less clear category, but important to the maintenance of credit, is that of the unsecured creditor-debtor relationship in which the debtor manipulates property to defeat the creditor's interest solely for that purpose and for no other. Perhaps the debtor foresees insolvency and tries to conceal property that a creditor might use to satisfy the debt. Perhaps the debtor never intends to satisfy the debt and manipulates property to make himself judgment-proof. Should the creditor be without recourse, and should the debtor's rights to deal with property be unrestricted in these kinds of cases?

The National Conference of Commissioners on Uniform State Laws (ULC) proposed the Uniform Fraudulent Conveyance Act (UFCA) in 1918 as an answer to that question. It was created to supersede the Statute of 13 Elizabeth which was enacted in some form by many states, and which introduced the concept of the fraudulent conveyance into the law of every American jurisdiction, with or without enactment. The UFCA was adopted in twenty-six states, and its provisions were incorporated into the Federal Bankruptcy Act.

In 1984, this 1918 Act was revised and renamed the Uniform Fraudulent Transfer Act (UFTA). The intent of the UFTA is the same as the UFCA - it classifies a category of transfers as fraudulent to creditors and provides creditors with a remedy for such transfers. The fundamental remedy is the recovery of the property for the creditor. Why a new Act at this time? The terminology of the UFCA had become considerably archaic, and needed to be modernized. The Bankruptcy Reform Act of 1978 changed the federal law on fraudulent transfers in significant ways, and made it imperative to reconsider state law. And creditor-debtor relationships have changed and become more complicated, so that the whole issue of fraudulent transfers needed rethinking. In 1984, the UFTA is ready to promote the modernization of this subject area of law.

UFTA creates a right of action for any creditor against any debtor and any other person who has received property from the debtor in a fraudulent transfer. A fraudulent transfer occurs when a debtor intends to hinder, delay, or defraud a creditor, or transfers property under certain conditions to another person without receiving reasonably equivalent value in return. But not all such transfers are fraudulent to every creditor.

UFTA distinguishes between present and future creditors, and specifies the kinds of transfers that are fraudulent to each of the two categories of creditors. Both present and future creditors may recover property when there is a transfer with intent to defraud. Both may recover when a transfer is made without receiving reasonably equivalent value when the result is to make the debtor's assets unreasonably small in relation to the business or transaction in which the debtor is engaged or about to be engaged. Also, present and future creditors can both recover when a debtor transfers property without receiving reasonably equivalent value when intending to incur debts beyond the ability to pay.

Present creditors, however, can recover property when it is transferred by a debtor to another person without receiving reasonably equivalent value if the debtor is insolvent or becomes insolvent as a result of the transfer. A transfer to an "insider" without receiving reasonably equivalent value when the debtor is insolvent, is also fraudulent to present creditors. The term "insider" is defined, and is someone with a special relationship to the debtor. Examples are relatives or business partners (when the debtor is a partner). To be liable, an "insider" must have reasonable cause to believe that the debtor is insolvent.

The fundamental relief for a creditor when there is a fraudulent transfer is recovery of the property from the person to whom it has been transferred. UFTA allows "avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim...." Whatever is necessary to obtain the property is provided for, including attachment, injunctive relief, appointment of a receiver or "any other relief the circumstances may require." If the creditor has reduced the claim to a judgment, the court may levy execution against the recovered assets. This means that the property can be sold to satisfy the amount of the judgment.

Much of the UFTA resembles the UFCA, its predecessor. What, then, are some of the differences? (A more detailed comparison is available from the ULC.) To begin with, the term "transfer" taken from the Federal Bankruptcy Act replaces the term "conveyance." UFCA uses the term "fair consideration" instead of "reasonably equivalent value." "Reasonably equivalent value" does not include the element of good faith as "fair consideration" does, and is more sharply defined than "fair consideration" is in the UFCA. UFTA overcomes the problem raised in the case of

Durrett v. Washington National Insurance Co., 621 F.2d 201 (5th Cir. 1980), a case that jeopardized mortgage foreclosure sales. Under UFTA, a properly conducted foreclosure sale is not a fraudulent transfer, notwithstanding the fact that it does not recover an amount somewhat near the actual market value of the property. The concept of the "insider" is new in the UFTA. UFTA provides for defenses of transferees and for a statute of limitations. Both issues are not addressed in the UFCA.

The Uniform Fraudulent Transfer Act continues the concept of a civil action for transfers fraudulent to creditors first created in the Statute of 13 Elizabeth, and comprehensively continued in the Uniform Fraudulent Conveyance Act. The new Act takes into account the considerable development in both law and practice in creditor-debtor relationships since 1918. The ULC hopes that it will be adopted uniformly in all states.

WALTER J. HICKEL, GOVERNOR

REPLY TO:

☐ 1031 W 4th AVENUE SUITE 200
ANCHORAGE, ALASKA 99501-1994
PHONE: (907) 276-3550
FAX: (907) 276-3697

☐ KEY BANK BUILDING
100 CUSHMAN ST. SUITE 400
FAIRBANKS, ALASKA 99701-4679
PHONE: (907) 452-1568
FAX: (907) 456-1317

☒ P.O. BOX 110300 — STATE CAPITOL
JUNEAU, ALASKA 99811-0300
PHONE: (907) 465-3600
FAX: (907) ~~463-5295~~ 465-6735

**DEPARTMENT OF LAW**

*OFFICE OF THE ATTORNEY GENERAL*

February 22, 1994

Hon. Bill Hudson
Chair, House Labor and Commerce Committee
Alaska House of Representatives
Room 108, State Capitol
Juneau, Alaska 99811

Dear Representative Hudson:

I am an assistant attorney general and a uniform law commissioner for Alaska representing the Department of Law.

I wanted to bring to your attention (HB 439), an Act concerning fraudulent transfers. This bill would bring Alaska's law into conformity with the other states that have adopted the uniform Act. Also, since Alaska law has not been updated for many years, this bill would update our state law to handle significant problems with our existing statutes concerning the sale or exchange of personal property done fraudulently to avoid creditors.

On behalf of the Alaska Uniform Law Commissioners, I would request a hearing on this important legislation.

Sincerely,

BRUCE M. BOTELHO
ATTORNEY GENERAL

By: Deborah E. Behr
Deborah E. Behr
Assistant Attorney General

DEB:cl

cc: Hon. Brian Porter
Alaska House of Representatives

All Alaska Uniform Law Commissioners

WALTER J. HICKEL, GOVERNOR

DEPARTMENT OF LAW

OFFICE OF THE ATTORNEY GENERAL

P.O. BOX 110300 - STATE CAPITOL
JUNEAU, ALASKA 99811-0300
PHONE: (907) 465-3600
FAX: (907) 463-5295

February 26, 1994

Honorable Bill Hudson, Chair
House Labor & Commerce Committee
State Capitol, Room 108
Juneau, AK 99811

Re: Hearing on Uniform Fraudulent Transfers Bill (HB 439)

Dear Representative Hudson:

Per your staff's request, enclosed are informational materials on HB 439 concerning uniform fraudulent transfers. The bill is modeled after the uniform law adopted by the Uniform Law Commissioners.

Persons planning to appear to testify are Mary Ellen Beardsley, Assistant Attorney General, and Gerald Kurtz, Uniform Law Commissioner for Alaska. We appreciate your scheduling them for testimony at the Anchorage Legislative Information Office.

If you need more information, please let me know.

Sincerely,

BRUCE M. BOTELHO
ATTORNEY GENERAL

By: Deborah E. Behr
Deborah E. Behr
Assistant Attorney General

DEB/bap

Enclosures

03-C321.H

BURR, PEASE & KURTZ
A PROFESSIONAL CORPORATION

DONALD A. BURR
L. S. KURTZ, JR.
OF COUNSEL

THEODORE M. PEASE, JR.
CHARLES P. FLYNN
ARDEN E. PAGE
RUSSELLYN S. CARRUTH

RALPH E. DUERRE
ANN C. LIBURD
JOHN C. SIEMERS
NELSON G. PAGE
THOMAS E. MEACHAM
PETER GRUENSTEIN
MICHAEL W. SEWRIGHT
PETER J. MAASSEN

MICHAEL W. SEVILLE
DAVID W. PEASE
THOMAS P. OWENS III
JOYCE WEAVER JOHNSON
NORA G. BARLOW

810 N STREET
ANCHORAGE, ALASKA 99501-3293
TELEPHONE: (907) 276-6100
FACSIMILE III: (907) 258-2530

TAX ID NO. 92-0037399

September 17, 1993

Representative Brian Porter
716 West Fourth Avenue, #640
Anchorage, AK 99501

HAND DELIVERED

Re: Uniform Fraudulent Transfer Act

Dear Representative Porter:

As promised in our telephone conversation today, I am forwarding two copies of the 1984 Uniform Fraudulent Transfer Act (UFTA) drafted by the National Conference of Commissioners on Uniform State Laws, two copies of Alaska's present law concerning fraudulent transfers, and a copy of a Department of Law Memorandum concerning the UFTA. Also enclosed are copies of a map and a chart from the Uniform Law Commission showing the 30 states which already have adopted the UFTA.

The heart of the UFTA is in section 4, which covers and augments the ground covered by existing Alaska Statutes 34.40.010. Section 4(a)(2) of the UFTA would eliminate the present Alaskan necessity of finding actual intent by a property transferor to hinder, delay or defraud a creditor in many situations where the transferor is obviously transferring assets solely to keep them out of the reach of the transferor's creditors.

Several Uniform Law Commissioners from Alaska agree with me that you are an ideal person to sponsor enactment of the UFTA in Alaska because of your related law enforcement and business background and because the legislation is desirable from the standpoint of legitimate business people and will cost the State of Alaska nothing. In fact, it is certain to help the State of Alaska loan programs in dealing with unscrupulous borrowers. When you return to Anchorage, I would appreciate having the opportunity to review the UFTA further with you.

In closing, the only parties I am representing in connection with this matter are the commissioners appointed by the State of Alaska to the Uniform Law Commission and myself. I have represented numerous parties (both debtors and creditors) in situations involving fraudulent or allegedly fraudulent transfers, and I am convinced the UFTA should be enacted in Alaska. Our present law technically was adopted in 1949 as noted in the Department of Law Memorandum, but the substance of it goes back to May 17, 1884, when the civil laws of Oregon were put in place in the State of Alaska. Looking back at Alaska Compiled Laws of 1949, 1933, and 1913, and Carter's Annotated Alaska Codes of 1900, I find no substantive changes in this area of law since the Oregon laws were installed here.

Please call me when you have had a chance to review these materials. Thank you for your time on the telephone today.

Sincerely,

BURR, PEASE & KURTZ

L. S. Kurtz, Jr.

dms
Enclosures as noted.

# STATE OF ALASKA

**DEPARTMENT OF LAW**

*OFFICE OF THE ATTORNEY GENERAL*

LSK

RECEIVED

AUG 30 1993

BURR, PEASE & KURTZ

*WALTER J. HICKEL, GOVERNOR*

*REPLY TO:*

☐ *1031 W 4th AVENUE SUITE 200*
*ANCHORAGE, ALASKA 99501-1994*
PHONE: (907) 276-3550
FAX: (907) 276-3697

☐ *KEY BANK BUILDING*
*100 CUSHMAN ST. SUITE 400*
*FAIRBANKS, ALASKA 99701-4679*
PHONE: (907) 452-1568
FAX: (907) 456-1317

☒ *P.O. BOX 110300 — STATE CAPITOL*
*JUNEAU, ALASKA 99811-0300*
PHONE: (907) 465-3600
FAX: (907) ~~465-2075~~ 465-6735

August 26, 1993

Lloyd S. Kurtz, Jr., Esq.
Burr, Pease & Kurtz
810 N Street
Anchorage, Alaska 99501

NO DOCKET DATE
DOCKETED

Dear Jerry:

At my request, Assistant Attorney General Mary Ellen Beardsley reviewed the Uniform Fraudulent Transfer Act (UFTA). Ms. Beardsley has a background in tax and bankruptcy law. She concludes that UFTA would be an improvement over existing Alaska law.

I thought that all of the Alaska Uniform Law Commissioners might want to review her memorandum in advance of our September teleconference.

Sincerely,

CHARLES E. COLE
ATTORNEY GENERAL

By: Deborah E. Behr
Deborah E. Behr
Assistant Attorney General

DEB:cl

03-C5LH

# MEMORANDUM

RECEIVED
AUG 30 1993
BURR, PEASE & KURTZ

State of Alaska
Department of Law

TO: Deborah Behr
Assistant Attorney General
Legislation/Regulation Section

DATE: August 24, 1993

FILE NO.:

TEL. NO.: 269-5201

SUBJECT: UFTA

RECEIVED
Department of Law
AUG 23 1993
AM 7 8 9 10 11 12 1 2 3 4 5 6 PM

FROM: Mary Ellen Beardsley MEB
Assistant Attorney General
Commercial Section-Anchorage

You have asked me to comment on the Uniform Fraudulent Transfer Act ("UFTA"), and whether it might be beneficial for Alaska to adopt the UFTA. After reviewing the material you provided as well as AS 34.40.010 - .130, Alaska's fraudulent conveyances statute, and the headnotes of cases dealing with fraudulent conveyances in Alaska, I conclude that the UFTA would be an improvement over Alaska's existing law.

As noted in Summers v. Hagen, ____ P.2d ____, No. 3961, May 28, 1993, at fn. 5 pg. 8, Alaska has not adopted the predecessor to the UFTA, the Uniform Fraudulent Conveyance Act ("UFCA"). Alaska's law was adopted in 1949, and has seen very little change since its adoption. However, since 1949, many changes in both state and federal law have occurred, particularly in the area of bankruptcy, and relationships between creditors and debtors have become more complex. Debtors, in particular, have found new and more imaginative ways of hiding assets from their creditors.

The Alaska law provides in general that a conveyance, whether in writing or otherwise, of real or personal property will be void if it was made "with the intent to hinder, delay or defraud creditors." (Emphasis added) AS 34.40.010. The cases cited under this statute (as well as AS 34.40.090) indicate that the existence of this fraudulent intent is a question of fact, that the court will never presume fraud and that the burden of proof is upon the plaintiff. This burden of proof can be extremely hard to prove. The only exception to this is found in AS 09.25.060 which creates a prima facia presumption of fraud when personal property is sold and the vendee does not take immediate delivery and does not have continued possession.

The UFTA, on the other hand, not only considers a transfer fraudulent if the debtor made the transfer with the intent to hinder, delay, or defraud any creditor (whether present or future), but, in certain cases, it mandates that the intent exists if the facts are as stated in the UFTA. The UFTA also sets out numerous non-exclusive factors to be considered by the court when

determining if the debtor had "actual intent." Proof of several of these factors will be strong evidence of the debtor's intent. The Court in Summers requires the plaintiff to establish "the specific intent of each participant in the scheme to hinder, delay or defraud." (Emphasis added) Id., at 8. Under the UFTA, the transferee's intent does not appear to be a factor in determining whether the transfer was fraudulent. In addition, when determining if adequate consideration was exchanged, the transferee's good faith is irrelevant. Finally, another important distinction is that under the UFTA a transfer to an "insider" will be considered per se fraudulent if the debtor was insolvent at the time and the "insider" had reason to believe that the debtor was insolvent.

Cases under the Alaska law also hold that an insolvent debtor may convey all or some of his property to one creditor and the conveyance will not be considered fraudulent. It is not improper nor unlawful to give preference to one creditor.

The UFTA differs substantially from the Alaska law for it considers as one of the badges of fraud the fact that the debtor was insolvent at the time of the transfer or that he became insolvent as a result of the transfer. The UFTA defines insolvency and even establishes a rebuttable presumption of insolvency if the debtor is not paying his debts as they become due.

The UFTA clearly outlines the remedies available to creditors, including attachment, injunctive relief, appointment of a receiver, or even execution against the property if the creditor's claim has been reduced to a judgment. The UFTA makes no distinction between whether the creditors' claims have matured or not. On the hand, the Court in Summers, Id., at fn. 6, pg. 9, indicated that general creditors will have a cause of action but they "must reduce their claims to judgments before asserting this cause of action. Prior to judgment, general creditors have no legal right to the property fraudulently conveyed."

Finally, Alaska law does not address the statute of limitations as to when a fraudulent conveyance action will be precluded. AS 09.10.070 establishes a two year statute of limitations for all tort actions, which is what a fraudulent conveyance would fall under. The UFTA specifically establishes statutes of limitations and sets out when the time period begins to run depending on which section of the UFTA the action is being brought under.

I have attempted to outline some of the differences between the UFTA and Alaska law. In conclusion, the UFTA is a modernization of the UFCA and incorporates the many changes which

have occurred over time in the area of fraudulent transfers. It conforms state law with applicable federal law (in particular, bankruptcy law) and overcomes potential problems that could arise because of the 5th Circuit case of Durrett v. Washington National Insurance Co., 621 F.2d 201 (5th Cir. 1980). It also eases the burden of proof upon the plaintiff slightly and places some responsibility upon the debtor to show why the transfer should not be voided. It may also make it more difficult for debtors to successfully hide or transfer their assets as a means of becoming judgment proof.

I hope this memo regarding the UFTA is of some assistance to you. If I can be of further assistance, please do not hesitate to contact me.

MEB:amh

# THE UNIFORM FRAUDULENT TRANSFER ACT

## CONTENTS

A Few Facts About

# THE UNIFORM FRAUDULENT TRANSFER ACT

**PURPOSE:** Providing a creditor with the capacity to procure assets a debtor has transferred to another person to keep them from being used to satisfy the debt.

**ORIGIN:** The Uniform Fraudulent Transfer Act, completed by the Uniform Law Commissioners in 1984, revises the Uniform Fraudulent Conveyance Act of 1918.

**ENDORSED BY:** American Bar Association

**STATE ADOPTIONS:**

| | | |
|---|---|---|
| Alabama | Maine | Ohio |
| Arizona | Minnesota | Oklahoma |
| Arkansas | Missouri | Oregon |
| California | Montana | Rhode Island |
| Colorado | Nebraska | South Dakota |
| Connecticut | Nevada | Texas |
| Florida | New Hampshire | Utah |
| Hawaii | New Jersey | Washington |
| Idaho | New Mexico | West Virginia |
| Illinois | North Dakota | Wisconsin |

**1993 INTRODUCTIONS:** Virginia

For any further information regarding the Uniform Fraudulent Transfer Act, please contact John McCabe or Katie Robinson at 312-915-0195.

(4/15/93)

# WHY STATES SHOULD ADOPT
# THE UNIFORM FRAUDULENT TRANSFER ACT

Are we only as good as the extent to which we honor our obligations? Many would argue for this proposition. And when our obligations are financial, the argument is reinforced by law. It is to this proposition that the Uniform Fraudulent Transfer Act is addressed. If we have acquired debt we should not be able to manipulate our assets so that creditors will be deprived of their value when we default on our debt. We should not be able to plan an artificial insolvency by transferring assets to others against the interests of our creditors.

The Uniform Fraudulent Transfer Act works as a deterrent, preventing such transgressions against obligations incurred, and provides creditors with a remedy when debtors transfer or hide assets that would otherwise be available to satisfy legitimate debts.

While the issue of obligation is preeminent, the economic issue is no less important. Credit is essential to the economic life of this country. Consumer credit, commercial credit, secured and unsecured credit enter into our lives, everyday. Credit remains available so long as those who extend it are given certain assurances about their rights at default. The Uniform Fraudulent Transfer Act provides assurances to creditors that help make credit available to all of us.

This economic issue leads directly to the issue of uniformity. The availability and the health of the credit mechanism require national standards. The principles of the old Uniform Fraudulent Conveyance Act became applicable to every person in every state because it was incorporated into the Federal Bankruptcy Act. Much of what is in the newer Fraudulent Transfer Act duplicates the Bankruptcy Reform Act of 1978. Uniformity has become not only a question of law between states, but also between state and federal law. Without uniformity, credit becomes less available, and the credit mechanism is less reliable. To avoid confusion and expense, the same rules must apply throughout the country. Public expectations are the same in every state and jurisdiction.

Associated with the issue of uniformity is the issue of modernity. The original Fraudulent Conveyance Act, which the Fraudulent Transfer Act replaces, was promulgated in 1918. Changes in federal bankruptcy law, in creditor-debtor relations in general, even in the rules governing the conduct of lawyers, make it clear that a modernization is overdue. The Uniform Fraudulent Transfers Act answers that immediate need.

# UNIFORM FRAUDULENT TRANSFER ACT

When we say a person "owns" something, we tend to think in all or nothing terms. Whatever a person owns is at that person's disposal - to sell, to give, to abandon, or to pledge as security for a debt. But relationships between people over property are never so simple or so unqualified. A creditor-debtor relationship, for example, may materially change an owner's power over the property owned. A mortgage, clearly, restricts what an owner may do with mortgaged real estate. The creditor has legally protected rights in the real estate securing the debt. Under Article 9 of the Uniform Commercial Code, secured creditors, also, obtain rights in collateral that are protected.

A less clear category, but important to the maintenance of credit, is that of the unsecured creditor-debtor relationship in which the debtor manipulates property to defeat the creditor's interest solely for that purpose and for no other. Perhaps the debtor foresees insolvency and tries to conceal property that a creditor might use to satisfy the debt. Perhaps the debtor never intends to satisfy the debt and manipulates property to make himself judgment-proof. Should the creditor be without recourse, and should the debtor's rights to deal with property be unrestricted in these kinds of cases?

The National Conference of Commissioners on Uniform State Laws (NCC) proposed the Uniform Fraudulent Conveyance Act (UFCA) in 1918 as an answer to that question. It was created to supersede the Statute of 13 Elizabeth which was enacted in some form by many states, and which introduced the concept of the fraudulent conveyance into the law of every American jurisdiction, with or without enactment. The UFCA was adopted in twenty-six states, and its provisions were incorporated into the Federal Bankruptcy Act.

In 1984, this 1918 Act was revised and renamed the Uniform Fraudulent Transfer Act (UFTA). The intent of the UFTA is the same as the UFCA - it classifies a category of transfers as fraudulent to creditors and provides creditors with a remedy for such transfers. The fundamental remedy is the recovery of the property for the creditor. Why a new Act at this time? The terminology of the UFCA had become considerably archaic, and needed to be modernized. The Bankruptcy Reform Act of 1978 changed the federal law on fraudulent transfers in significant ways, and made it imperative to reconsider state law. And creditor-debtor relationships have changed and become more complicated, so that the whole issue of fraudulent transfers needed rethinking. In 1984, the UFTA is ready to promote the modernization of this subject area of law.

UFTA creates a right of action for any creditor against any debtor and any other person who has received property from the debtor in a fraudulent transfer. A fraudulent transfer occurs when a debtor intends to hinder, delay, or defraud a creditor, or transfers property under certain conditions to another person without receiving reasonably equivalent value in return. But not all such transfers are fraudulent to every creditor.

UFTA distinguishes between present and future creditors, and specifies the kinds of transfers that are fraudulent to each of the two categories of creditors. Both present and future creditors may recover property when there is a transfer with intent to defraud. Both may recover when a transfer is made without receiving reasonably equivalent value when the result is to make the debtor's assets unreasonably small in relation to the business or transaction in which the debtor is engaged or about to be engaged. Also, present and future creditors can both recover when a debtor transfers property without receiving reasonably equivalent value when intending to incur debts beyond the ability to pay.

Present creditors, however, can recover property when it is transferred by a debtor to another person without receiving reasonably equivalent value if the debtor is insolvent or becomes insolvent as a result of the transfer. A transfer to an "insider" without receiving reasonably equivalent value when the debtor is insolvent, is also fraudulent to present creditors. The term "insider" is defined, and is someone with a special relationship to the debtor. Examples are relatives or business partners (when the debtor is a partner). To be liable, an "insider" must have reasonable cause to believe that the debtor is insolvent.

The fundamental relief for a creditor when there is a fraudulent transfer is recovery of the property from the person to whom it has been transferred. UFTA allows "avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim...." Whatever is necessary to obtain the property is provided for, including attachment, injunctive relief, appointment of a receiver, or "any other relief the circumstances may require." If the creditor has reduced the claim to a judgment, the court may levy execution against the recovered assets. This means that the property can be sold to satisfy the amount of the judgment.

Much of the UFTA resembles the UFCA, its predecessor. What, then, are some of the differences? (A more detailed comparison is available from the ULC.) To begin with, the term "transfer" taken from the Federal Bankruptcy Act replaces the term "conveyance." UFCA uses the term "fair consideration" instead of "reasonably equivalent value." "Reasonably equivalent value" does not include the element of good faith as "fair consideration" does, and is more sharply defined than "fair consideration" is in the UFCA. UFTA overcomes the problem raised in the case of

Durrett v. Washington National Insurance Co., 621 F.2d 201 (5th Cir. 1980), a case that jeopardized mortgage foreclosure sales. Under UFTA, a properly conducted foreclosure sale is not a fraudulent transfer, notwithstanding the fact that it does not recover an amount somewhat near the actual market value of the property. The concept of the "insider" is new in the UFTA. UFTA provides for defenses of transferees and for a statute of limitations. Both issues are not addressed in the UFCA.

The Uniform Fraudulent Transfer Act continues the concept of a civil action for transfers fraudulent to creditors first created in the Statute of 13 Elizabeth, and comprehensively continued in the Uniform Fraudulent Conveyance Act. The new Act takes into account the considerable development in both law and practice in creditor-debtor relationships since 1918. The ULC hopes that it will be adopted uniformly in all states.

# THE UNIFORM FRAUDULENT TRANSFER ACT

by

FRED H. MILLER
Professor of Law at the University of Oklahoma

## Section by Section Analysis of the Act

Section 1 contains definitions. Section 2 also contains the definition of "insolvent," and Section 3 the definition of "value." The definition of "asset" in Section 2(2), together with the latter definitions of "insolvent" and "value," in a general sense formulate the core concept of the act: the transfer of an asset (or incurring an obligation) for inadequate value by an insolvent debtor or one rendered insolvent by the transaction is a fraudulent transfer. Subsection 3(B) is worth particular note in this respect because it overrules for state law the controversial holding in Durrett v. Washington Nat. Ins. Co., 621 F.2d 201 (5th Cir. 1980), that a regularly conducted mortgage foreclosure that produces a price "too low" may be avoided as a fraudulent conveyance. By clouding property titles the Durrett rule virtually is a self-fulfilling prophecy.

Section 4 Subsection a(1) states the basic rule of the act: a transfer made or an obligation incurred with actual intent to hinder, delay or defraud creditors is actionable by creditors. How does a creditor prove the debtor's actual intent? Subsection b sets out "badges of fraud" if several of these appear it is strong evidence. Subsection a(2), on the other hand, sets out two cases where the law decrees the intent exists if the facts are as stated.

Section 5 states two further cases where the law decrees the transaction is fraudulent, but only as to present creditors and not also as to creditors arising later as is the case for transfers covered by Section 5.

Section 6 defines when a transaction occurs. It occurs when it can prejudice the rights of third parties, and not when it actually occurs between the parties to it. For example, a creditor does not need this act to set aside a fraudulent security interest that is never filed; the creditor can defeat that interest under the Uniform Commercial Code. Subsection 5 of this Section also states the time when an obligation is incurred.

Section 7 describes the remedies a creditor has to attack and avoid a fraudulent transfer or obligation.

Section 8, however, protects a good faith purchaser for reasonably equivalent value who did not share in the debtor's fraudulent purpose and subsequent good faith transferees for value who are sufficiently remote. Subsection (d) also gives a good faith transferee or obligee against whom the transaction can be avoided protection for any value given.

Subsection (e) is important as protecting lease terminations and security interest enforcement against "Durrett type" attacks, and Subsection (f) allows "workouts" and the like to occur.

Section 9 prescribes statutes of limitation specifically for the act.

Section 10 states the act is supplemented by other law and Section 11 specifies that in interpreting the act, precedent from other states that have enacted it should be used to maintain uniformity.

Section 12 provides the title.

Section 13 repeals the current statutes on the subject, including any old predecessor versions of this act.

# DURRETT, THE UNIFORM FRAUDULENT TRANSFER ACT, AND FEDERAL BANKRUPTCY LAW - SORTING OUT CONFUSION

There has been much confusion over the relationship of mortgage foreclosures, however done, and fraudulent conveyance statutes, including the 1984 Uniform Fraudulent Transfer Act (UFTA). The confusion results from a single, now notorious case, Durrett v. Washington Nat. Ins. Co., 621 F.2d 201 (5th Cir. 1980). The Court, in Durrett, held a noncollusive mortgage foreclosure conducted pursuant to Texas law a constructively fraudulent transfer under Section 67d of the Bankruptcy Act. The Bankruptcy Act has fraudulent transfer provisions directly analogous to the UFTA.

Durrett has not been followed in all circuits of the federal courts. It has been directly rejected in the Sixth and Ninth Circuits, for example. Its influence on state law in the interpretation of the 1918 Uniform Fraudulent Conveyance Act (UFCA) and those states still following the common law is not yet clear. Much speculation attends the possibilities in that regard, however.

Why is Durrett so important? Its holding calls the validity of the bulk of mortgage foreclosure sales into question. Almost never do such sales realize the current market price for real estate bought and sold in the ordinary course. A key element in fraudulent conveyance analysis is the concept of "fair consideration" or "reasonably equivalent value." In Durrett, the foreclosure sale realized less than 70% of the alleged market value, and was a fraudulent transfer for that fact.

As a result of Durrett, buyers in foreclosure sales lose assurance of title. Lenders cannot be sure of lending practices. The uncertainty that Durrett forecasts has large economic impact in real estate markets.

UFTA attempts to alleviate the difficulties that Durrett suggests. In Section 3(b), value is "reasonably equivalent value" if given in "a regularly conducted, noncollusive foreclosure sale or execution of a power of sale for the acquisition or disposition of the interest of the debtor upon default under a mortgage, deed of trust, or security agreement." Adoption of this provision would preclude a Durrett type of holding in any state adopting UFTA. Only private, non-public types of transfers, such as some kinds of deed in lieu of foreclosure, would be vulnerable. But these are exactly the kinds of transfers UFTA is designed to remedy anyway. UFTA Section 3(b) removes the uncertainty that Durrett has created, insofar as state law is concerned.

We must be clear, however, on the distinction between federal and state law, the Bankruptcy Act and state fraudulent conveyance law. Durrett still applies in federal bankruptcy law,

# UNIFORM FRAUDULENT TRANSFER ACT

## 1984 ACT

### Historical Note

The Uniform Fraudulent Transfer Act was approved by the National Conference of Commissioners on Uniform State Laws in 1984. The complete text of the act, the prefatory note and comments are set forth in this supplement.

### PREFATORY NOTE

The Uniform Fraudulent Conveyance Act was promulgated by the Conference of Commissioners on Uniform State Laws in 1918. The Act has been adopted in 25 jurisdictions, including the Virgin Islands. It has also been adopted in the sections of the Bankruptcy Act of 1938 and the Bankruptcy Reform Act of 1978 that deal with fraudulent transfers and obligations.

The Uniform Act was a codification of the "better" decisions applying the Statute of 13 Elizabeth. See Analysis of H.R. 12339, 74th Cong., 2d Sess. 213 (1936). The English statute was enacted in some form in many states, but, whether or not so enacted, the voidability of fraudulent transfer was part of the law of every American jurisdiction. Since the intent to hinder, delay, or defraud creditors is seldom susceptible of direct proof, courts have relied on badges of fraud. The weight given these badges varied greatly from jurisdiction, and the Conference sought to minimize or eliminate the diversity by providing that proof of certain fact combinations would conclusively establish fraud. In the absence of evidence of the existence of such facts, proof of a fraudulent transfer was to depend on the evidence of actual intent. An important reform effected by the Uniform Act was the elimination of any requirement that a creditor have obtained a judgment or execution returned unsatisfied before bringing an action to avoid a transfer as fraudulent. See American Surety Co. v. Conner, 251 N.Y. 1, 166 N.E. 783, 67 A.L.R. 244 (1929) (per C.J. Cardozo).

The Conference was persuaded in 1979 to appoint a committee to undertake a study of the Uniform Act with a view to preparing the draft of a revision. The Conference was influenced by the following considerations:

(1) The Bankruptcy Reform Act of 1978 has made numerous changes in the section of that Act dealing with fraudulent transfers and obligations, thereby substantially reducing the correspondence of the provisions of the federal bankruptcy law on fraudulent transfers with the Uniform Act.

(2) The Committee on Corporate Laws of the Section of Corporations, Banking & Business Law of the American Bar Association, engaged in revising the Model Corporation Act, suggested that the Conference review provisions of the Uniform Act with a view to determining whether the Acts are consistent in respect to the treatment of dividend distributions.

(3) The Uniform Commercial Code, enacted at least in part by all 50 states, had substantially modified related rules of law regulating transfers of personal property, notably by facilitating the making and perfection of security transfers against attack by unsecured creditors.

(4) Debtors and trustees in a number of cases have avoided foreclosure of security interests by invoking the fraudulent transfer section of the Bankruptcy Reform Act.

(5) The Model Rules of Professional Conduct adopted by the House of Delegates of the American Bar Association on August 2, 1983, forbid a lawyer to counsel or to assist a client in conduct that the lawyer knows is fraudulent.

The Drafting Committee appointed by the Conference held its first meeting in January of 1983. A first reading of a draft of the revision of the Uniform Fraudulent Conveyance Act was had at the Conference's meeting in Boca Raton, Florida, on July 27, 1983. The Committee held four meetings in addition to a meeting held in connection with the Conference meeting in Boca Raton. Meetings were also attended by the following representatives of interested organizations:

Robert Rosenberg, Esq., of the American Bar Association;

Richard Cherin, Esq., of the Commercial Financial Services Committee of the Corporation, Banking and Business Law Section of the American Bar Association;

Robert Zinman, Esq., of the American College of Real Estate Lawyers;

Bruce Bernstein, Esq., of the National Commercial Finance Association;

Ernest E. Specks, Esq. the Real Property, Probate and Trust Law Section of the American Bar Associati

The Committee determined to rename the Act the Uniform Fraudulent Transfer Act in recognition of its applicability to transfers of personal property as well as real property, "conveyance" having a connotation restricting it to a transfer of personal property. As noted in Comment (2) accompanying § 1(2) and Comment (8) accompanying § 4, however, this Act, like the original Uniform Act, does not purport to cover the whole law of voidable transfers and obligations. The limited scope of the original Act did not impair its effectiveness in achieving uniformity in the areas covered. See McLaughlin, Application of the Uniform Fraudulent Conveyance Act, 46 Harv.L.Rev. 404, 405 (1933).

The basic structure and approach of the Uniform Fraudulent Conveyance Act are preserved in the Uniform Fraudulent Transfer Act. There are two sections in the new Act delineating what transfers and obligations are fraudulent. Section 4(a) is an adaptation of three sections of the U.F.C.A.; § 5(a) is an adaptation of another section of the U.F.C.A.; and § 5(b) is new. One section of the U.F.C.A. (§ 8) is not carried forward into the new Act because deemed to be redundant in part and in part susceptible of inequitable application. Both Acts declare a transfer made or an obligation incurred with actual intent to hinder, delay, or defraud creditors to be fraudulent. Both Acts render a transfer made or obligation incurred without adequate consideration to be constructively fraudulent—*i.e.*, without regard to the actual intent of the parties—under one of the following conditions:

(1) the debtor was left by the transfer or obligation with unreasonably small assets for a transaction or the business in which he was engaged;

(2) the debtor intended to incur, or believed that he would incur, more debts than he would be able to pay; or

(3) the debtor was insolvent at the time or as a result of the transfer or obligation.

As under the original Uniform Fraudulent Conveyance Act a transfer or obligation that is constructively fraudulent because insolvency concurs with or follows failure to receive adequate consideration is voidable only by a creditor in existence at the time the transfer occurs or the obligation is incurred. Either an existing or subsequent creditor may avoid a transfer or obligation for inadequate consideration when accompanied by the financial condition specified in § 4(a)(2)(i) or the mental state specified in § 4(a)(2)(ii).

Reasonably equivalent value is required in order to constitute adequate consideration under the revised Act. The revision follows the Bankruptcy Code in eliminating good faith on the part of the transferee or obligee as an issue in the determination of whether adequate consideration is given by a transferee or obligee. The new Act, like the Bankruptcy Act, allows the transferee or obligee to show good faith in defense after a creditor establishes that a fraudulent transfer has been made or a fraudulent obligation has been incurred. Thus a showing by a defendant that a reasonable equivalent has been given in good faith for a transfer or obligation is a complete defense although the debtor is shown to have intended to hinder, delay, or defraud creditors.

A good faith transferee or obligee who has given less than a reasonable equivalent is nevertheless allowed a reduction in a liability to the extent of the value given. The new Act, like the Bankruptcy Code, eliminates the provision of the Uniform Fraudulent Conveyance Act that enables a creditor to attack a security transfer on the ground that the value of the property transferred is disproportionate to the debt secured. The premise of the new Act is that the value of the interest transferred for security is measured by and thus corresponds exactly to the debt secured. Foreclosure of a deotor's interest by a regularly conducted, noncollusive sale on default under a mortgage or other security agreement may not be avoided under the Act as a transfer for less than a reasonably equivalent value.

The definition of insolvency under the Act is adapted from the definition of the term in the Bankruptcy Code. Insolvency is presumed from proof of a failure generally to pay debts as they become due.

The new Act adds a new category of fraudulent transfer, namely, a preferential transfer by an insolvent insider to a creditor who had reasonable cause to believe the debtor to be insolvent. An insider is defined in much the same way as in the Bankruptcy Code and includes a relative, also defined as in the Bankruptcy Code, a director or officer of a corporate debtor, a partner, or a person in control of a debtor. This provision is available only to an existing creditor. Its premise is that an insolvent debtor is obliged to pay debts to creditors not related to him before paying those who are insiders.

The new Act omits any provision directed particularly at transfers or obligations of insolvent partnership debtors. Under § 8 of the Uniform Fraudulent Conveyance Act any transfer made or obligation incurred by an insolvent partnership to a partner is fraudulent without regard to intent or adequacy of consideration. So categorical a condemnation of a partnership transaction with a partner may unfairly prejudice the interests of a partner's separate creditors. The new Act also omits as redundant a provision in the original Act that makes fraudulent a transfer made or obligation incurred by an insolvent partnership for less than a fair consideration to the partnership.

Section 7 lists the remedies available to creditors under the new Act. It eliminates as unnecessary and confusing a differentiation made in the original Act between the remedies available to holders of matured claims and those holding unmatured claims. Since promulgation of the Uniform Fraudulent Conveyance Act the Supreme Court has imposed restrictions on the availability and use of prejudgment remedies. As a result many states have amended their statutes and rules applicable to such remedies, and it is frequently unclear whether a state's procedures include a prejudgment remedy against a fraudulent transfer or obligation. A bracketed paragraph is included in Section 7 for adoption by those states that elect to make such a remedy available.

Section 8 prescribes the measure of liability of a transferee or obligee under the Act and enumerates defenses. Defenses against avoidance of a preferential transfer to an insider under § 5(b) include an adaptation of defenses available under § 547(c)(2) and (4) of the Bankruptcy Code when such a transfer is sought to be avoided as a preference by the trustee in bankruptcy. In addition a preferential transfer may be justified when shown to be made pursuant to a good faith effort to stave off forced liquidation and rehabilitate the debtor. Section 8 also precludes avoidance, as a constructively fraudulent transfer, of the termination of a lease on default or the enforcement of a security interest in compliance with Article 9 of the Uniform Commercial Code.

The new Act includes a new section specifying when a transfer is made or an obligation is incurred. The section specifying the time when a transfer occurs is adapted from Section 548(d) of the Bankruptcy Code. Its premise is that if the law prescribes a mode for making the transfer a matter of public record or notice, it is not deemed to be made for any purpose under the Act until it has become such a matter of record or notice.

The new Act also includes a statute of limitations that bars the right rather than the remedy on expiration of the statutory periods prescribed. The law governing limitations on actions to avoid fraudulent transfers among the states is unclear and full of diversity. The Act recognizes that laches and estoppel may operate to preclude a particular creditor from pursuing a remedy against a fraudulent transfer or obligation even though the statutory period of limitations has not run.

## UNIFORM FRAUDULENT TRANSFER ACT

A Few Facts About
*THE UNIFORM STATUTORY RULE AGAINST PERPETUITIES*

PURPOSES: To conform the rule against perpetuities to its original purpose of preventing perpetual trusts without defeating reasonable trusts; and to minimize and simplify perpetuity litigation as much as possible.

ORIGIN: Completed by the Uniform Law Commissioners in 1986. Amended in 1990 by adding section 1(e). Became part of Uniform Probate Code in 1990 and of Uniform Act on Intestacy, Wills, and Donative Transfers in 1991.

ENDORSED BY: House of Delegates of American Bar Association, on unanimous recommendation of the Council of the ABA Section of Real Property, Probate and Trust Law

Board of Regents of American College of Trust and Estate Counsel (unanimous)

Board of Governors of American College of Real Estate Lawyers (unanimous)

Joint Editorial Board for Uniform Probate Code (unanimous)

Leading scholars, including Gregory S. Alexander (Cornell), Olin L. Browder, Jr. (Michigan), Verner F. Chaffin (Georgia), Mary Louise Fellows (Minnesota), Edward C. Halbach, Jr. (Cal. Berkeley), Thomas L. Jones (Alabama), Sheldon F. Kurtz (Iowa), John H. Langbein (Yale), Allan F. Smith (Michigan), Robert A. Stein (Minnesota), and Richard V. Wellman (Georgia).

STATE ADOPTIONS:

| | | |
|---|---|---|
| California * | Massachusetts | New Jersey * |
| Colorado * | Michigan | New Mexico * (1992) |
| Connecticut | Minnesota | North Dakota * |
| Florida | Montana | Oregon |
| Georgia | Nebraska | South Carolina |
| Indiana * | Nevada | |

For further information, please contact Lawrence W. Waggoner, Hutchins Hall, University of Michigan Law School, Ann Arbor, MI 48109-1215, telephone 313-763-2586, or John M. McCabe or Katie Robinson, NCCUSL, 676 North St. Clair St., Suite 1700, Chicago, IL 60611, telephone 312-915-0195.

* 1991 Adoptions

# Statutory Rule Against Perpetuities (1986) (1990)


* Introduced this year

JULY 16, 1993

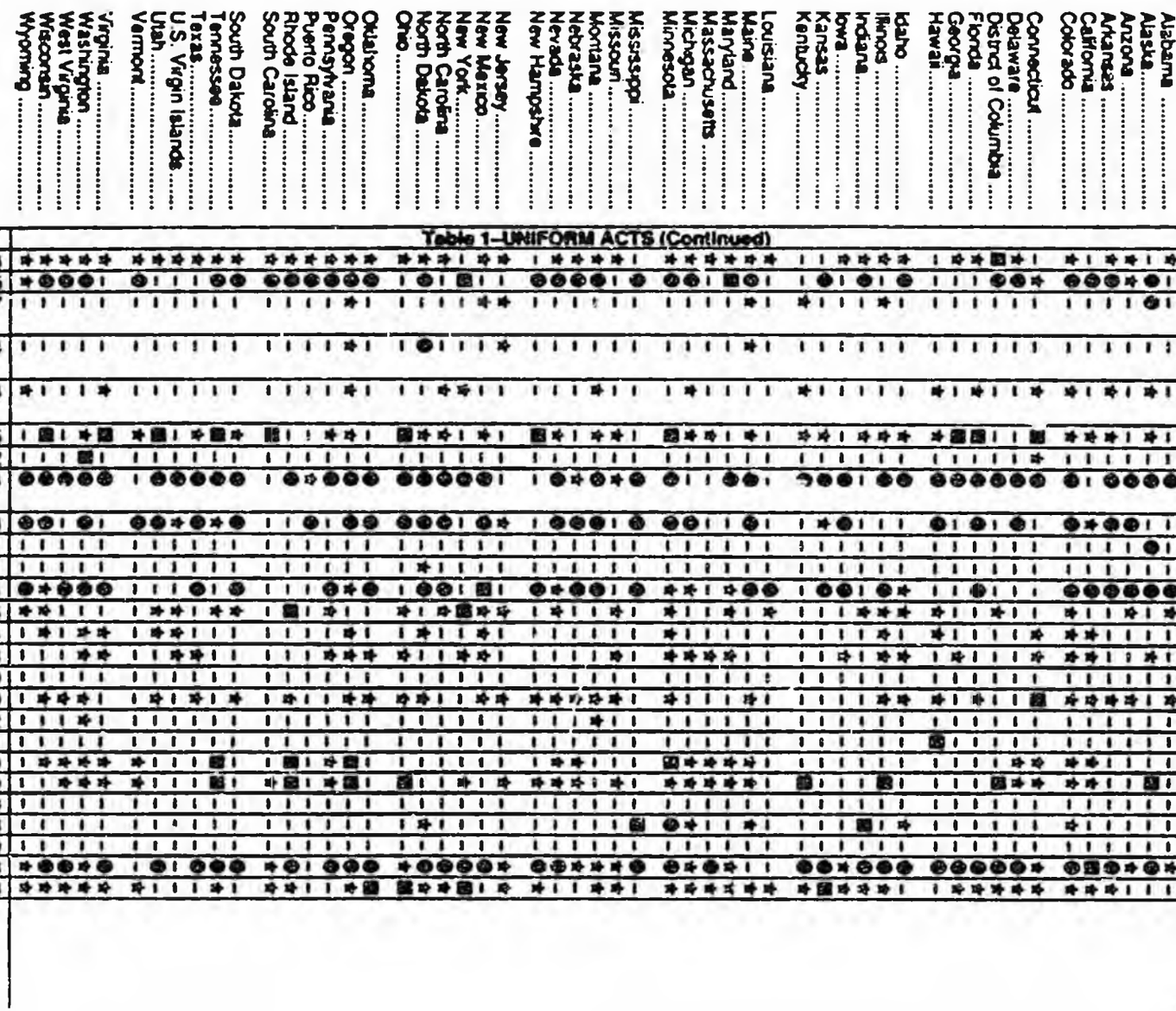


**Table 1–UNIFORM ACTS (Continued)**

| | |
|---|---|
| 44 | Declaratory Judgments (1922) |
| 35 | Determination of Death (1978) (1980) |
| 7 | Disclaimer of Transfers by Will, Intestacy or Appointment (1973) (1978) |
| 4 | Disclaimer of Transfers Under Nontestamentary Instruments (1973) (1978) |
| 14 | Disposition of Community Property Rights at Death (1971) |
| 36 | Division of Income for Tax Purposes (1957) |
| 2 | Dormant Mineral Interests (1986) |
| 44 | Enforcement of Foreign Judgments (1948) (1964) |
| 33 | Evidence, Rules of (1953) (1974) (1986) (1986) |
| 1 | Exemptions (1976) (1979) |
| 1 | Extradition and Rendition (1980) |
| 34 | Federal Lien Registration (1978) (1982) |
| 26 | Fiduciaries (1922) |
| 14 | Foreign Money Claims (1989) |
| 23 | Foreign Money Judgments Recognition (1962) |
| 0 | Franchise and Business Opportunities (1987) |
| 30 | Fraudulent Transfer (1984) |
| 2 | Health-Care Information (1985) |
| 1 | Information Practices Code (1980) |
| 20 | Interstate Arbitration of Death Taxes (1943) |
| 29 | Interstate Compromise of Death Taxes (1943) |
| 0 | Interstate Family Support (1992) |
| 8 | Jury Selection and Service (1970) (1971) |
| 0 | Land Security Interest (1985) |
| 48 | Limited Partnership (1976) (1983) (1985) |
| 38 | Management of Institutional Funds (1972) |

# Fraudulent Transfer (1984)


* Introduced this year

JULY 16, 1993

D. ISION OF LEGAL SERVICES
LEGISLATIVE AFFAIRS AGENCY
STATE OF ALASKA

(907) 465-3867 or 465-2450
FAX (907) 465-2029
Mail Stop 3101

130 Seward Street, Suite 409
Juneau, Alaska 99801-2105

**MEMORANDUM** January 21, 1994

**SUBJECT:** Sectional Summary of Uniform Fraudulent Transfer Act. (Work Order No. 8-LS1461\A)

**TO:** Representative Brian Porter

**FROM:** David R. Dierdorff
Revisor of Statutes

You have requested a sectional summary of the above-described bill.

As a preliminary matter, note that a sectional summary of a bill should not be considered an authoritative interpretation of the bill and the bill itself is the best statement of its contents. If you would like an interpretation of the bill as it may apply to a particular set of circumstances, please advise.

This summary relies heavily on the prefatory notes and comments to the Uniform Act that were prepared by the National Conference of Commissioners on Uniform State Laws (NCCUSL). In most instances, the text will be that of the NCCUSL, with modifications only as necessary to correct section references and the like.

## INTRODUCTION AND OVERVIEW

The Uniform Fraudulent Transfer Act was approved by the National Conference of Commissioners on Uniform State Laws in 1984 and by the American Bar Association on February 18, 1985. This Act was preceded by the Uniform Fraudulent Conveyance Act, promulgated by the Conference of Commissioners on Uniform State Laws in 1918 and adopted in 25 jurisdictions, including the Virgin Islands. The 1918 Act has also been adopted in the sections of the Bankruptcy Act of 1938 and the Bankruptcy Reform Act of 1978 that deal with fraudulent transfers and obligations.

Alaska did not adopt the earlier Act. Current Alaska law, found at AS 34.40, derives from late 19th century Oregon law, and has received little legislative attention. Even though Alaska did not enact the 1918 Act, the official commentary's references to it and to differences between the new Uniform Act and it, are helpful in understanding

the substantive effect of the bill. Consequently, this memorandum retains those references.

The 1918 Uniform Act was a codification of the "better" decisions applying the Statute of 13 Elizabeth. See Analysis of H.R. 12339, 74th Cong., 2d Sess. 213 (1936). The English statute was enacted in some form in many states, but, whether or not so enacted, the voidability of a fraudulent transfer was part of the law of every American jurisdiction (*c.f.* AS 34.40.010). Because the intent to hinder, delay, or defraud creditors is seldom susceptible of direct proof, courts have relied on "badges of fraud." The weight given these badges varied greatly between jurisdictions, and the Conference sought to minimize or eliminate the diversity by providing that proof of certain fact combinations would conclusively establish fraud. In the absence of evidence of the existence of such facts, proof of a fraudulent transfer was to depend on the evidence of actual intent. An important reform effected by the 1918 Uniform Act was the elimination of any requirement that a creditor have obtained a judgment or execution returned unsatisfied before bringing an action to avoid a transfer as fraudulent. See American Surety Co. v. Conner, 251 N.Y. 1, 166 N.E. 783, 67 A.L.R. 244 (1929) (per C.J. Cardozo).

The NCCUSL was persuaded in 1979 to appoint a committee to undertake a study of the 1918 Uniform Act with a view to preparing the draft of a revision. The Conference was influenced by the following considerations:

(1) The Bankruptcy Reform Act of 1978 made numerous changes in the section of that Act dealing with fraudulent transfers and obligations, thereby substantially reducing the correspondence of the provisions of the federal bankruptcy law on fraudulent transfers with the Uniform Act.

(2) The Committee on Corporate Laws of the Section of Corporations, Banking & Business Law of the American Bar Association, engaged in revising the Model Corporation Act, suggested that the Conference review provisions of the Uniform Act with a view to determining whether the Acts are consistent in respect to the treatment of dividend distributions.

(3) The Uniform Commercial Code, enacted at least in part by all 50 states, had substantially modified related rules of law regulating transfers of personal property, notably by facilitating the making and perfection of security transfers against attack by unsecured creditors.

(4) Debtors and trustees in a number of cases have avoided foreclosure of security interests by invoking the fraudulent transfer section of the Bankruptcy Reform Act.

(5) The Model Rules of Professional Conduct adopted by the House of Delegates of the American Bar Association on August 2, 1983, forbid a lawyer to counsel or to assist a client in conduct that the lawyer knows is fraudulent.

The drafting committee determined to rename the Act the Uniform Fraudulent Transfer Act in recognition of its applicability to transfers of personal property as well as real property, "conveyance" having a connotation restricting it to a transfer of personal property. This Act, like the original Uniform Act, does not purport to cover the whole law of voidable transfers and obligations. The limited scope of the original Act did not impair its effectiveness in achieving uniformity in the areas covered. See McLaughlin, Application of the Uniform Fraudulent Conveyance Act, 46 Harv.L.Rev. 404, 405 (1933).

The basic structure and approach of the 1918 Act are preserved in the Uniform Fraudulent Transfer Act. There are two sections in the new Act delineating what transfers and obligations are fraudulent. Section 4(a) (Sec. 34.41.030(a)) is an adaptation of three sections of the 1918 Act: § 5(a) (Sec. 34.41.040(a)) is an adaptation of another section of that Act and § 5(b) (Sec. 34.41.040(b)) is new. One section of the 1918 Act (§ 8) is not carried forward into the new Act because it was believed to be redundant in part and in part susceptible of inequitable application. Both Acts declare a transfer made or an obligation incurred with actual intent to hinder, delay, or defraud creditors to be fraudulent. Both Acts render a transfer made or obligation incurred without adequate consideration to be constructively fraudulent -- *ie.*, without regard to the actual intent of the parties -- under one of the following conditions:

(1) the debtor was left by the transfer or obligation with unreasonably small assets for a transaction or the business in which the debtor was engaged;

(2) the debtor intended to incur, or believed that the debtor would incur, more debts than the debtor would be able to pay; or

(3) the debtor was insolvent at the time or as a result of the transfer or obligation.

As under the 1918 Act a transfer or obligation that is constructively fraudulent because insolvency concurs with or follows failure to receive adequate consideration is voidable only by a creditor in existence at the time the transfer occurs or the obligation is incurred. Either an existing or subsequent creditor may avoid a transfer or obligation for inadequate consideration when accompanied by the financial condition specified in Sec. 34.41.030(a)(2)(A) or the mental state specified in Sec. 34.41.030(a)(2)(B).

Reasonably equivalent value is required in order to constitute adequate consideration under the revised Act. The revision follows the Bankruptcy Code in eliminating good faith on the part of the transferee or obligee as an issue in the determination of whether adequate consideration is given by a transferee or obligee. The new Act, like the Bankruptcy Act, allows the transferee or obligee to show good faith in defense after a creditor establishes that a fraudulent transfer has been made or a fraudulent obligation has been incurred. Thus, a showing by a defendant that a reasonable equivalent has been given in good faith for a transfer or obligation is a complete defense although the debtor is shown to have intended to hinder, delay, or defraud creditors.

A good faith transferee or obligee who has given less than a reasonable equivalent is nevertheless allowed a reduction in a liability to the extent of the value given. The new Act, like the Bankruptcy Code, eliminates the provision of the 1918 Act that enables a creditor to attack a security transfer on the ground that the value of the property transferred is disproportionate to the debt secured. The premise of the new Act is that the value of the interest transferred for security is measured by and thus corresponds exactly to the debt secured. Foreclosure of a debtor's interest by a regularly conducted, noncollusive sale on default under a mortgage or other security agreement may not be avoided under the Act as a transfer for less than a reasonably equivalent value.

The definition of insolvency under the Act is adapted from the definition of the term in the Bankruptcy Code. Insolvency is presumed from proof of a failure generally to pay debts as they become due.

The new Act adds a new category of fraudulent transfer, namely, a preferential transfer by an insolvent insider to a creditor who had reasonable cause to believe the debtor to be insolvent. An insider is defined in much the same way as in the Bankruptcy Code and includes a relative, also defined as in the Bankruptcy Code, a director or officer of a corporate debtor, a partner, or a person in control of a debtor. This provision is available only to an existing creditor. Its premise is that an insolvent debtor is obliged to pay debts to creditors not related to the debtor before paying those who are insiders.

The new Act omits any provision directed particularly at transfers or obligations of insolvent partnership debtors. Under § 8 of the 1918 Act, any transfer made or obligation incurred by an insolvent partnership to a partner was deemed fraudulent without regard to intent or adequacy of consideration. So categorical a condemnation of a partnership transaction with a partner may unfairly prejudice the interests of a partner's separate creditors. The new Act also omits as redundant a provision in the 1918 Act that makes fraudulent a transfer made or obligation incurred by an insolvent partnership for less than a fair consideration to the partnership.

Section 34.41.060 lists the remedies available to creditors under the new Act. It eliminates as unnecessary and confusing a differentiation made in the 1918 Act between the remedies available to holders of matured claims and those holding unmatured claims. Since promulgation of the 1918 Act, the United States Supreme Court has imposed restrictions on the availability and use of prejudgment remedies. As a result many states have amended their statutes and rules applicable to such remedies, and it is frequently unclear whether a state's procedures include a prejudgment remedy against a fraudulent transfer or obligation. Paragraph (a)(2) is included in Sec. 34.41.060 to make such a remedy available.

Section 34.41.070 prescribes the measure of liability of a transferee or obligee under the Act and enumerates defenses. Defenses against avoidance of a preferential transfer to an insider under Sec. 34.41.040(b) include an adaptation of defenses available under § 547(c)(2) and (4) of the Bankruptcy Code when such a transfer is sought to be avoided as a preference by the trustee in bankruptcy. In addition a preferential transfer may be justified when shown to be made pursuant to a good faith effort to stave off forced liquidation and rehabilitate the debtor. Section 34.41.070 also precludes avoidance, as a constructively fraudulent transfer, of the termination of a lease on default or the enforcement of a security interest in compliance with Article 9 of the Uniform Commercial Code (AS 45.09).

The new Act includes a new section specifying when a transfer is made or an obligation is incurred. The section specifying the time when a transfer occurs is adapted from § 548(d) of the Bankruptcy Code. Its premise is that if the law prescribes a mode for making the transfer a matter of public record or notice, it is not deemed to be made for any purpose under the Act until it has become such a matter of record or notice.

The new Act also includes a statute of limitations that bars the right rather than the remedy on expiration of the statutory periods prescribed. The law governing limitations on actions to avoid fraudulent transfers among the states is unclear and full of diversity. The Act recognizes that laches and estoppel may operate to preclude a particular creditor from pursuing a remedy against a fraudulent transfer or obligation even though the statutory period of limitations has not run.

## SECTIONAL ANALYSIS AND COMMENTARY

**Section 1.** Enacts the Uniform Fraudulent Transfer Act as a new chapter, AS 34.41. The chapter consists of the following provisions:

**Sec. 34.41.010.** This section sets out the circumstances under which a debtor is deemed to be insolvent.

**OFFICIAL COMMENTARY**

(1) Subsection (a) is derived from the definition of "insolvent" in § 101 (29)(A) of the Bankruptcy Code. The definition in subsection (a) and the correlated definition of partnership insolvency in subsection (c) contemplate a fair valuation of the debts as well as the assets of the debtor. As under the definition of the same term in § 2 of the 1918 Act, exempt property is excluded from the computation of the value of the assets. See Sec. 34.41.110(2). For similar reasons, interests in valid spendthrift trusts and interests in tenancies by the entireties that cannot be severed by a creditor of only one tenant are not included. See the comment to Sec. 34.41.110(2), *infra*. Since a valid lien also precludes an unsecured creditor from collecting the creditor's claim from the encumbered interest in a debtor's property, both the encumbered interest and the debt secured thereby are excluded from the computation of insolvency under this Act. See Sec. 34.41.110(2) and subsection (e) of this section.

(2) Subsection (b) establishes a rebuttable presumption of insolvency from the fact of general nonpayment of debts as they become due. Such general nonpayment is a ground for the filing of an involuntary petition under § 303(h)(1) of the Bankruptcy Code. See also AS 45.01.201(24) (Uniform Commercial Code), which, in part, declares a person to be "insolvent" who "has ceased to pay the person's debts in the ordinary course of business or cannot pay the person's debts as they become due." The presumption imposes on the party against whom the presumption is directed the burden of proving that the nonexistence of insolvency as defined in subsection (a) is more probable than its existence. See Uniform Rules of Evidence (1974 Act), Rule 310(a). The 1974 Uniform Rule 301(a) conforms to the Final Draft of Federal Rule 301 as submitted to the United States Supreme Court by the Advisory Committee on Federal Rules of Evidence. "The so-called 'bursting bubble' theory, under which a presumption vanishes upon the introduction of evidence which would support a finding of the nonexistence of the presumed fact, even though not believed is rejected as according presumptions too 'slight and evanescent' an effect." Advisory Committee's Note to Rule 301. See also 1 J. Weinstein & M. Berger, Evidence (1982).

The presumption is established in recognition of the difficulties typically imposed on a creditor in proving insolvency in the bankruptcy sense, as provided in subsection (a). See generally Levit, The Archaic Concept of Balance-Sheet Insolvency, 47 Am.Bankr.L.J. 215 (1973). Not only is the relevant information in the possession of a noncooperative debtor but the debtor's records are more often than not incomplete and inaccurate. As a practical matter, insolvency is most cogently evidenced by a general cessation of payment of debts, as has long been recognized by the laws of other countries and is now reflected in the Bankruptcy Code. See Honsberger, Failure to Pay One's Debts Generally as They Become Due: The Experience of France and Canada, 54 Am.Bankr.L.J. 153 (1980); J. MacLachlan,

Bankruptcy 13, 63-64, 436 (1956). In determining whether a debtor is paying its debts generally as they become due, the court should look at more than the amount and due dates of the indebtedness. The court should also take into account such factors as the number of the debtor's debts, the proportion of those debts not being paid, the duration of the nonpayment, and the existence of bona fide disputes or other special circumstances alleged to constitute an explanation for the stoppage of payments. The court's determination may be affected by a consideration of the debtor's payment practices prior to the period of alleged nonpayment and the payment practices of the trade or industry in which the debtor is engaged. The case law that has developed under § 303(h)(1) of the Bankruptcy Code has not required a showing that a debtor has failed or refused to pay a majority in number and amount of the person's debts in order to prove general nonpayment of debts as they become due. See, *e.g.*, Hill v. Cargill Inc. (*In re* Hill), 8 B.R. 779, 3 C.B.C.2d 920 (Bk.D.Minn.1981) (non-payment of three largest debts held to constitute general nonpayment, although small debts were being paid); *In re* All Media Properties, Inc., 5 B.R. 126, 6 B.C.D. 586, 2 C.B.C.2d 449 (Bk.S.D.Tex.1980) (missing significant number of payments or regularly missing payments significant in amount said to constitute general nonpayment; missing payments on more than 50% of aggregate of claims said not to be required to show general nonpayment; nonpayment for more than 30 days after billing held to establish nonpayment of a debt when it is due); *In re* Kreidler Import Corp., 4 B.R. 256, 6 B.C.D. 608, 2 C.B.C.2d 159 (Bk.D.Md. 1980) (nonpayment of one debt constituting 97% of debtor's total indebtedness held to constitute general nonpayment). A presumption of insolvency does not arise from nonpayment of a debt as to which there is a genuine bona fide dispute, even though the debt is a substantial part of the debtor's indebtedness. *Cf.* 11 U.S.C. 303(h)(1), as amended by § 426(b) of Public Law No. 98-882, the Bankruptcy Amendments and Federal Judgeship Act of 1984.

(3) Subsection (c) is derived from the definition of partnership insolvency in § 101(29)(B) of the Bankruptcy Code. The definition conforms generally to the definition of the same term in § 2(2) of the 1918 Act.

(4) Subsection (d) follows the approach of the definition of "insolvency" in § 101(29) of the Bankruptcy Code by excluding from the computation of the value of the debtor's assets any value that can be realized only by avoiding a transfer of an interest formerly held by the debtor or by discovery or pursuit of property that has been fraudulently concealed or removed.

(5) Subsection (e) is new. It makes clear the purpose not to render a person insolvent under this section by counting as a debt an obligation secured by property of the debtor that is not counted as an asset. See also comments to subsection (a), *supra*, and Sec. 34.41.110(2), *infra*.

**Sec. 34.41.020.** This section defines "value" as used in various contexts in this Act, frequently with a qualifying adjective. The word appears in the following provisions:

Sec. 34.41.030(a)(2) ("reasonably equivalent value");
Sec. 34.41.030(b)(8) ("value ... reasonably equivalent");
Sec. 34.41.040(a) ("reasonably equivalent value");
Sec. 34.41.040(b) ("present, reasonably equivalent value");
Sec. 34.41.070(a) ("reasonably equivalent value");
Sec. 34.41.070(b), (c), (d), and (e) ("value");
Sec. 34.41.070(f)(1) ("new value"); and
Sec. 34.41.070(f)(3) ("present value").

**OFFICIAL COMMENTARY**

(1) Subsection (a) is adapted from § 548(d)(2)(A) of the Bankruptcy Code. See also § 3(a) of the 1918 Act. The definition in the section is not exclusive. "Value" is to be determined in light of the purpose of the Act to protect a debtor's estate from being depleted to the prejudice of the debtor's unsecured creditors. Consideration having no utility from a creditor's viewpoint does not satisfy the statutory definition. The definition does not specify all the kinds of consideration that do not constitute value for the purposes of this Act -- *e.g.*, love and affection. See, *e.g.*, United States v. West, 299 F.Supp. 661, 666 (D.Del. 1969).

(2) Subsection (a) does not indicate what is "reasonably equivalent value" for a transfer or obligation. Under this Act, as under § 548(a)(2) of the Bankruptcy Code, a transfer for security is ordinarily for a reasonably equivalent value notwithstanding a discrepancy between the value of the asset transferred and the debt secured, since the amount of the debt is the measure of the value of the interest in the asset that is transferred. See, *e.g.*, Peoples-Pittsburgh Trust Co., v. Holy Family Polish Nat'l Catholic Church, Carnegie, Pa., 341 Pa. 390, 19 A.2d 360 (1941). If, however, a transfer purports to secure more than the debt actually incurred or to be incurred, it may be found to be for less than a reasonably equivalent value. See *e.g.*, *In re* Peoria Braumeister Co., 138 F.2d 520, 523 (7th Cir. 1943) (chattel mortgage securing a $3,000 note held to be fraudulent when the debt secured was only $2,500); Hartford Acc. & Indemnity Co. v. Jirasek, 254 Mich. 131, 140, 235 N.W. 836, 839 (1931) (quitclaim deed given as mortgage held to be fraudulent to the extent the value of the property transferred exceeded the indebtedness secured). If the debt is a fraudulent obligation under this Act, a transfer to secure it as well as the obligation would be vulnerable to attack as fraudulent. A transfer to satisfy or secure an antecedent debt owed an insider is also subject to avoidance under the conditions specified in Sec. 34.41.040(b).

(3) Section 3(a) of the 1918 Act has been thought not to recognize that an unperformed promise could constitute fair consideration. See McLaughlin, Application of the Uniform Fraudulent Conveyance Act, 46 Harv.L. Rev. 404, 414 (1933). Courts construing these provisions of the prior law nevertheless have held unperformed promises to constitute value in a variety of circumstances. See, *e.g.*, Harper v. Lloyd's Factors, Inc., 214 F.2d 662 (2d Cir. 1954) (transfer of money for promise of factor to discount transferor's purchase-money notes given to fur dealer); Schlecht v. Schlecht, 168 Minn. 168, 176-77, 209 N.W. 883, 886-87 (1926) (transfer for promise to make repairs and improvements on transferor's homestead); Farmer's Exchange Bank v. Oneida Motor Truck Co., 202 Wis. 266, 232 N.W. 536 (1930) (transfer in consideration of assumption of certain of transferor's liabilities); see also Hummel v. Cernocky, 161 F.2d 685 (7th Cir. 1947) (transfer in consideration of cash, assumption of a mortgage, payment of certain debts, and agreement to pay other debts). Likewise a transfer in consideration of a negotiable note discountable at a commercial bank, or the purchase from an established, solvent institution of an insurance policy, annuity, or contract to provide care and accommodations clearly appears to be for value. On the other hand, a transfer for an unperformed promise by an individual to support a parent or other transferor has generally been held voidable as a fraud on creditors of the transferor. See, *e.g.*, Springfield Ins. Co. v. Fry, 267 F.Supp. 693 (N.D.Okla. 1967); Sandler v. Parlapiano, 236 App.Div. 70, 258 N.Y.Supp. 88 (1st Dep't 1932); Warwick Municipal Employees Credit Union v. Higham, 106 R.I. 363, 259 A.2d 852 (1969); Hulsether v. Sanders, 54 S.D. 412, 223 N.W. 335 (1929); Cooper v. Cooper, 22 Tenn.App. 473, 477, 124 S.W.2d 264, 267 (1939); Note, Rights of Creditors in Property Conveyed in Consideration of Future Support, 45 Iowa L.Rev. 546, 550-62 (1960). This Act adopts the view taken in the cases cited in determining whether an unperformed promise is value.

(4) Subsection (b) rejects the rule of such cases as Durrett v. Washington Nat. Ins. Co., 621 F.2d 201 (5th Cir.1980) (nonjudicial foreclosure of a mortgage avoided as a fraudulent transfer when the property of an insolvent mortgagor was sold for less than 70% of its fair value), and Abramson v. Lakewood Bank & Trust Co., 647 F.2d 547 (5th Cir.1981), cert. denied, 454 U.S. 1164 (1982) (nonjudicial foreclosure held to be fraudulent transfer if made without fair consideration). Subsection (b) adopts the view taken in Lawyers Title Ins. Corp. v. Madrid (*In re* Madrid), 21 B.R. 424 (B.A.P. 9th Cir.1982), aff'd on another ground, 725 F.2d 1197 (9th Cir.1984), that the price bid at a public foreclosure sale determines the fair value of the property sold. Subsection (b) prescribes the effect of a sale meeting its requirements, whether the asset sold is personal or real property. The rule of this subsection applies to a foreclosure by sale of the interest of a vendee under an installment land contract in accordance with applicable law that requires or permits the foreclosure to be effected by a sale in the same manner as the foreclosure of a mortgage. See G. Osborne, G. Nelson, & D. Whitman, Real Estate Finance Law 83-84, 95-97 (1979). The premise of the subsection is that "a sale of the collateral by the secured party as the normal

consequence of default ... [is] the safest way of establishing the fair value of the collateral ...." 2 G. Gilmore, Security Interests in Personal Property 1227 (1965).

If a lien given an insider for a present consideration is not perfected as against a subsequent bona fide purchaser or is so perfected after a delay following an extension of credit secured by the lien, foreclosure of the lien may result in a transfer for an antecedent debt that is voidable under Sec. 34.41.040(b), *infra*. Subsection (b) does not apply to an action under Sec. 34.41.030(a)(1) to avoid a transfer or obligation because made or incurred with actual intent to hinder, delay, or defraud any creditor.

(5) Subsection (c) is an adaptation of § 547(c)(1) of the Bankruptcy Code. A transfer to an insider for an antecedent debt may be voidable under Sec. 34.41.-040(b), *infra*.

**Sec. 34.41.030.** This section describes the transfers that are fraudulent as to present and future creditors and sets out factors that may be given consideration in determining whether the requisite intent to defraud was present.

**OFFICIAL COMMENTARY**

(1) Paragraph (a)(1) is derived from § 7 of the 1918 Act. Factors appropriate for consideration in determining actual intent under paragraph (a)(1) are specified in subsection (b).

(2) Paragraph (a)(2) is derived from §§ 5 and 6 of the 1918 Act but substitutes "reasonably equivalent value" for "fair consideration." The transferee's good faith was an element of "fair consideration" as defined in § 3 of the 1918 Act, and lack of fair consideration was one of the elements of a fraudulent transfer as defined in four sections of that Act. The transferee's good faith is irrelevant to a determination of the adequacy of the consideration under the new Act, but lack of good faith may be a basis for withholding protection of a transferee or obligee under Sec. 34.41.070, *infra*.

(3) Unlike the 1918 Act as originally promulgated, this Act does not prescribe different tests when a transfer is made for the purpose of security and when it is intended to be absolute. The premise of this Act is that when a transfer is for security only, the equity or value of the asset that exceeds the amount of the debt secured remains available to unsecured creditors and thus cannot be regarded as the subject of a fraudulent transfer merely because of the encumbrance resulting from an otherwise valid security transfer. Disproportion between the value of the asset securing the debt and the size of the debt secured does not, in the absence of circumstances indicating a purpose to hinder, delay, or defraud creditors, constitute

an impermissible hindrance to the enforcement of other creditors' rights against the debtor-transferor. *Cf.* AS 45.09.311 (Uniform Commercial Code).

(4) Subparagraph (a)(2)(A) of this section is an adaptation of § 5 of the 1918 Act, but substitutes "unreasonably small [assets] in relation to the business or transaction" for "unreasonably small capital." The reference to "capital" in the 1918 Act is ambiguous in that it may refer to net worth or to the par value of stock or to the consideration received for stock issued. The special meanings of "capital" in corporation law have no relevance in the law of fraudulent transfers. The subparagraph focuses attention on whether the amount of all the assets retained by the debtor was inadequate, *i.e.*, unreasonably small, in light of the needs of the business or transaction in which the debtor was engaged or about to engage.

(5) Subsection (b) is a nonexclusive catalogue of factors appropriate for consideration by the court in determining whether the debtor had an actual intent to hinder, delay, or defraud one or more creditors. Proof of the existence of any one or more of the factors enumerated in subsection (b) may be relevant evidence as to the debtor's actual intent, but does not create a presumption that the debtor has made a fraudulent transfer or incurred a fraudulent obligation. The list of factors includes most of the badges of fraud that have been recognized by the courts in construing and applying the Statute of 13 Elizabeth and § 7 of the 1918 Act. Proof of the presence of certain badges in combination establishes fraud conclusively -- *i.e.*, without regard to the actual intent of the parties -- when they concur as provided in (a)(2) of this section or in Sec. 34.41.040. The fact that a transfer has been made to a relative or to an affiliated corporation has not been regarded as a badge of fraud sufficient to warrant avoidance when unaccompanied by any other evidence of fraud. The courts have uniformly recognized, however, that a transfer to a closely related person warrants close scrutiny of the other circumstances, including the nature and extent of the consideration exchanged. See 1 G. Glenn, Fraudulent Conveyances and Preferences § 307 (Rev. ed. 1940). The second, third, fourth, and fifth factors listed are all adapted from the classic catalogue of badges of fraud provided by Lord Coke in Twyne's Case, 3 Coke 80b, 76 Eng.Rep. 809 (Star Chamber 1601). Lord Coke also included the use of a trust and the recitation in the instrument of transfer that it "was made honestly, truly, and bona fide," but the use of the trust is fraudulent only when accompanied by elements or badges specified in this Act, and recitals of "good faith" can no longer be regarded as significant evidence of a fraudulent intent.

(6) In considering the factors listed in subsection (b) a court should evaluate all the relevant circumstances involving a challenged transfer or obligation. Thus the court may appropriately take into account all indicia negativing as well as those suggesting fraud, as illustrated in the following reported cases:

(a) Whether the transfer or obligation was to an insider: Salomon v. Kaiser (*In re* Kaiser), 722 F.2d 1574, 1582-83 (2d Cir.1983) (insolvent debtor's

purchase of two residences in the name of his spouse and the creation of a dummy corporation for the purpose of concealing assets held to evidence fraudulent intent); Banner Construction Corp. v. Arnold, 128 So.2d 893 (Fla.Dist.App. 1961) (assignment by one corporation to another having identical directors and stockholders constituted a badge of fraud); Travelers Indemnity Co. v. Cormaney, 258 Iowa 237, 138 N.W.2d 50 (1965) (transfer between spouses said to be a circumstance that shed suspicion on the transfer and that with other circumstances warranted avoidance); Hatheway v. Hanson, 230 Iowa 386, 297 N.W. 824 (1941) (transfer from parent to child said to require a critical examination of surrounding circumstances, which, together with other indicia of fraud, warranted avoidance); Lumpkins v. McPhee, 59 N.M. 442, 286 P.2d 299 (1955) (transfer from daughter to mother said to be indicative of fraud but transfer held not to be fraudulent due to adequacy of consideration and delivery of possession by transferor).

(b) Whether the transferor retained possession or control of the property after the transfer: Harris v. Shaw, 224 Ark. 150, 272 S.W.2d 53 (1954) (retention of property by transferor said to be a badge of fraud and, together with other badges, to warrant avoidance of transfer); Stephens v. Reginstein, 89 Ala. 561, 8 So. 68 (1890) (transferor's retention of control and management of property and business after transfer held material in determining transfer to be fraudulent); Allen v. Massey, 84 U.S. (17 Wall.) 351 (1872) (joint possession of furniture by transferor and transferee considered in holding transfer to be fraudulent); Warner v. Norton, 61 U.S. (20 How.) 448 (1857) (surrender of possession by transferor deemed to negate allegations of fraud).

(c) Whether the transfer or obligation was concealed or disclosed: Walton v. First National Bank, 13 Colo. 265, 22 P. 440 (1889) (agreement between parties to conceal the transfer from the public said to be one of the strongest badges of fraud); Warner v. Norton, 61 U.S. (20 How.) 448 (1857) (although secrecy said to be a circumstance from which, when coupled with other badges, fraud may be inferred, transfer was held not to be fraudulent when made in good faith and transferor surrendered possession); W.T. Raleigh Co. v. Barnett, 253 Ala. 433, 44 So.2d 585 (1950) (failure to record a deed in itself said not to evidence fraud, and transfer held not to be fraudulent).

(d) Whether, before the transfer was made or obligation was incurred, a creditor sued or threatened to sue the debtor: Harris v. Shaw, 224 Ark. 150, 272 S.W.2d 53 (1954) (transfer held to be fraudulent when causally connected to pendency of litigation and accompanied by other badges of fraud); Pergrem v. Smith, 255 S.W.2d 42 (Ky.App.1953) (transfer in anticipation of suit deemed to be a badge of fraud; transfer held fraudulent when accompanied by