SAPRONOV & ASSOCIATES, P.C.
ATTORNEYS AT LAW

info@wstelecomlaw.com
www.wstelecomlaw.com

1300 I STREET, NW, SUITE 400
WASHINGTON, D.C. 20005
TEL. 770.309.0462

5555 GLENRIDGE CONNECTOR SUITE 200
ATLANTA, GEORGIA 30342
TEL. 770.399.9100

Client & Friends Alert[1]

Corporate Transparency Act (CTA):

Implications for Investment Transactions

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I. CTA Highlights for Investment Transactions.

Largely ignored by many small businesses, the Corporate Transparency Act (CTA), its hour come round at last, will soon be upon them.[2] Its legislative purpose is to track down money launderers and other bad guys. Effective January 1, 2024,[3] the CTA expands these enforcement efforts through new reporting requirements that affect an estimated 33 million of such small businesses (including limited liability companies, corporations, and others).[4] The overwhelming majority of course have nothing to do with money laundering or any other illicit activities. Even so, unless otherwise exempt, all such existing companies must report information to the U.S. government about their beneficial owners by January 1, 2025.

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[1]While accurate to the best of our knowledge, the discussion herein is for tutorial purposes only. It is not to be deemed a legal opinion or legal advice. Should you wish to discuss this disclaimer (or require legal assistance), please contact us at wsapronov@wstelecomlaw.com

[2] FinCEN's published CTA Rules (https://www.fincen.gov/boi) require all small business entities (so-called "reporting companies") to disclose their "beneficial owners". For a brief synopsis of the CTA, please see https://wstelecomlaw.com/2024/01/corporate-transparency-act-cta-a-synopsis/

[3] 31 U.S.C. Section 5336. The CTA is a part of the Anti-Money Laundering Act of 2020, which is included in the National Defense Authorization Act for Fiscal Year 2021, Pub. L. No. 116-283, §§ 6001-6511, 134 Stat. 3388 (2021) ("NDAA") .

[4]https://www.fincen.gov/what-money-laundering#:~:text=Money%20laundering%20involves%20disguising%20financial,with%20an%20apparently%20legal%20source

U.S. money laundering enforcement is conducted by the Financial Crimes Enforcement Network (FinCEN) (https://www.fincen.gov/). **Failure to comply with the CTA can trigger significant civil penalties ($500 per day up to $10,000) and up to two years of imprisonment**. **Unauthorized use or disclosure of Beneficial Ownership Information (BOI) can trigger up to $250,000 in fines and up to five years' imprisonment**.

For many, the reporting requirement on first blush appears simple. The reporting company must identify those holding twenty five percent (25 %) or more ownership, its officers, and other decision makers – all presumably straight forward.

But for reporting companies seeking investors, the simplicity is deceptive.

First – there is "substantial control", an amorphous concept that, if interpreted expansively, can potentially extend CTA disclosure requirements to investors, minority equity holders, LLC members, limited partners, and other individuals having the power to influence corporate decision making.

Second, FinCEN distinguishes a company's decision makers from its advisors (e.g., investment bankers, attorneys): the former are beneficial owners requiring disclosure, the latter do not.

How to understand, anticipate and prepare for these CTA complications when undertaking investment transactions is the subject of this alert.

II. Who Owns or Controls a Reporting Company?

Whether or not a reporting company must identify investors and other participants in financial transactions as beneficial owners depends on whether they have "**substantial control**". FinCEN broadly defines such controlling persons as any individual who:

i. "Exercises substantial control over the entity. This includes individuals who can make significant decisions (e.g., corporate governance, finances, reorganization) on behalf of the company, such as officers, directors, or similar decision makers, regardless of title.[5]

ii. "Owns or *controls* at least 25% of the ownership interests in the reporting company. This category includes individuals that directly or indirectly *control* ownership interests that meet the 25 % threshold. Examples cited by FinCEN

[5] https://www.fincen.gov/boi-faqs#D_1. Question D.3.

of ownership interest include equity shares, convertible instruments, warrants, and contractual arrangements. [6]

ii. "Has substantial influence over important company decisions." This catch-all category sweeps in individuals with the ability to direct, determine, or *influence* significant matters of the company, even without official corporate title or direct ownership.

In short, FinCEN's guidance as to who exercises "substantial control" of a company sweeps in investors with board seats, significant voting power, or any rights that give them the rights to direct, determine or "influence" important company matters. Facially, this would clearly apply to any shareholder's rights to appoint board members and, arguably, to any voting powers that collectively – e.g., by a shareholder voting block" – can control important company decisions.

But what about "silent partners" or other "stealth beneficial owners"? [7] For example, the "manager" of a manager-managed limited liability company (LLC) would presumably be a beneficial owner. But what about other members that have power to limit or otherwise have influence over the manager's authority under the operating agreement? The same question may arise in the case of limited partnerships whose limited partners may have rights to "influence" the general partner. The answer requires careful review of the controlling documents.

III. Corporate Decision Makers vs. Advisors.

Further, for purposes of CTA disclosure, the distinction between a reporting company's decision makers and its advisors is also not that clear. Both can have "substantial influence" over important company decisions.

For example, would a company's investment banker assisting in merger or bankruptcy negotiations be an "important decision maker", thereby requiring disclosure as a beneficial owner?

The answer is probably **no**. FinCEN says that an individual exercises substantial control over a reporting company if he or she:

> ".. serves as a senior officer … has authority over the appointment or removal of any senior officer or a majority of the board of directors; directs, determines, decides, or has

[6] https://www.fincen.gov/boi-faqs#D_1. Question D.4.

[7] See J. Lushis and P. Hutcheon, "Filing Requirements under the Corporate Transparency Act: Stealth Beneficial Owners, August 12, 2024, https://natlawreview.com/article/filing-requirements-under-corporate-transparency-act-steal-beneficial-owners.

> substantial influence over important matters,,, or has any other form of substantial control …" [8]

Advisors (*e.g.*, investment bankers, consultants, outside counsel) who have neither actual decision-making authority, nor the corporate power to make decisions, are omitted from this litany. Their exclusion by FinCEN from this list thus strongly suggests that advisors do not have to be disclosed as beneficial owners.

1. <u>Early-Stage Investors and "Later Rounds</u>."

But what about early stage "angel" investors in a start-up reporting company or mezzanine investors in a later financing round? For example, would a "seed capital" investor having convertible preferred equity shares (of less than 25 percent ownership interest) but with substantial governance rights – such as board appointments – be considered a beneficial owner.

The answer is **probably yes**. FinCEN provides the following list of ownership interests:

> "Shares of equity, voting rights, or other means of establishing ownership, convertible instruments, such as preferred shares, convertible debt, or warrants…options (*e.g.*, puts, calls) or other rights to acquire or dispose of equity or voting interests…any other instrument, contract, arrangement, understanding, relationship, or mechanism used to establish ownership."[9]

If an early-stage angel investor or mezzanine investor holds convertible preferred shares, warrants, or other instruments that could convert into ownership or confer economic rights in the future, these are considered ownership interests under FinCEN's definitions.

Note that CTA identifies only individuals as beneficial owners, not corporate entities such as a venture capital fund, private equity firm, or other institutional investor. Thus, the reporting requirement for such entities would attach to the individual(s) who either "control" it or own 25% or more of its equity.

In short, much uncertainty surrounds CTA's implications for investment transactions. These and other questions require important examination and merit consideration early in the investment negotiation process.

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[8] FinCEN Final Rule **(31CFR § 1010.380(d)(1))**

[9] FinCEN Final Rule **(31 CFR § 1010.380(d)(2))**

For assistance with CTA compliance or if you related questions regarding investment or other financing transactions, please contact us at wsapronov@wstelecomlaw.com or by text at (770) 309-0462.