

ABSTRACT

The Rise of the Statutory Business Trust

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INTRODUCTION

Beginning with the Delaware Business Trust Act of 1988,¹ _____ states have resurrected the trust as a viable mode of business organization by transmogrifying the common law business trust into the statutory business trust (SBT).² Moreover, a Delaware-style business trust statute is pending in New York;³ a business trust statute is being drafted in California;⁴ and a uniform act—the Uniform Statutory Trust Entity Act—is in draft form and likely will be promulgated in final form in 2007.⁵

The volume of commercial activity organized in SBTs, which I estimate at roughly \$___ trillion, is stunning. Three out of every four mutual funds (a \$___ trillion industry) is organized as a trust, implying that about half of all American households own a beneficial interest in a modern business trust. The SBT is widely used in the booming structured finance industry, which is worth at least \$ ___illion. The SBT is used also to obtain favorable tax treatment for certain real estate exchanges, a transactional structure

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Although the author is the reporter for the Uniform Statutory Trust Entity Act (USTEA), the views expressed in this paper are those of the author alone and do not necessarily represent the views of the Uniform Law Commission or the USTEA drafting committee.

¹12 Del. Code §§3801-3862 (renamed the Delaware Statutory Trust Act in 19___).

²Appendix A [omitted] collects the states' business trust statutes.

³[Citation]

⁴The California draft is being prepared under the aegis of the California Bar Association's Partnership and LLCs Committee.

⁵See http://www.law.upenn.edu/bll/ulc/ubta/2006amdraft_rev.htm.

validated by a recent IRS Revenue Ruling.⁶

⁶Rev. Rul. 2004-86, 2004-2 C.B. 191.

In spite of the integral role of SBTs in capital markets and commercial transactions, the SBT is hardly mentioned in contemporary scholarship on,⁷ or in the teaching of,⁸ business organizations or trusts and estates. This paper aims to remedy that regrettable lacuna by offering the first systematic study—descriptive, theoretical, and empirical—or the rise of the SBT.

I. THE RISE AND FALL OF THE COMMON LAW BUSINESS TRUST

A. The Trust as Organizational Form

A trust is a fiduciary relationship in which the trustee holds legal title to specified property and is charged with managing that property for the benefit of one or more beneficiaries.

B. Use of the Trust to Escape Regulation

Unlike the corporate form and limited liability unincorporated associations, the common law trust arises from private agreement without the need for a filing with the state and associated state regulatory oversight. Hence, in the late 1800s and early 1900s entrepreneurs regularly used the common law business trust to escape the then-pervasive regulation of the corporate form. Indeed, the prominence of the trust as a mode of business organization explains why we have antitrust law, not competition or monopoly law, as it is known abroad.

C. Uncertainty: Limited Liability and Public Policy

The common law business trust proved to be an imperfect alternative to the corporation for organizing operating enterprises. Some courts refused to recognize the

⁷ With one exception, the academic slate is clean. See Tamar Frankel, *The Delaware Business Trust Act Failure as the New Corporate Law*, 23 *Cardozo L. Rev.* 325 (2001). Frankel's study, however, is limited to specific criticisms of the Delaware Business Trust Act. Other academics, including me, have occasionally glanced at the SBT in the context of more general studies of the trust as a mode of economic organization. See John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 *Yale L. J.* 165, ___ (1997); Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 *N.Y.U. L. Rev.* 434, ___ (1998); Henry Hansmann, Reinier Kraakman, & Richard Squire, *Law and the Rise of the Firm*, 119 *Harv. L. Rev.* 1333, ___ (2006); Steven L. Schwartz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 *Bus. Law.* 559, ___ (2003); Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 *Cornell L. Rev.* 621, ___ (2004); George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 *Harv. L. Rev.* 1102, ___ (2004). Finally, in a symposium on noncorporate forms of business organization, I suggested a research agenda for the study of SBTs, see Robert H. Sitkoff, *Trust as Uncorporation: A Research Agenda*, 2005 *U. Ill. L. Rev.* 31. In the same symposium Henry Hansmann, Reinier Kraakman, and Richard Squire [insert]. The practitioner literature is modest. See [insert].

⁸The casebooks on business associations ignore business trusts altogether. Indeed, the only coverage of the business trust in a book in this genre is William A. Gregory & Thomas R. Hurst, *Unincorporated Business Associations* 786-800 (2d ed. 2002). [check/update]

Except for ___ pages in Dukeminier et al. and ___pages in Vollmar et al., the casebooks on trusts and estates likewise ignore the business trust.

validity of the common law business trust. Others treated common law business trusts like corporations, subjecting them to the regulatory limits contained in the state's corporate code. Still others recognized the validity of the business trust but not limited liability for its investors; these courts reasoned that limited liability should be available only with a public filing. Yet a further problem was that the old-style common law business trust did not draw a sharp line between the trustee's personal assets and those of the trust.

For these reasons, once the more invasive regulatory limits on the corporation fell away the corporate form came to dominate the trust form as a mode of business organization. But interest in the trust as a form of business organization did not die out completely. To satisfy this interest, the states began enacting business trust legislation.

II. THE RISE OF THE STATUTORY BUSINESS TRUST

A. The Business Trust Statutes

Responding to the legal uncertainty over the status of the business trust at common law, at least twenty-nine states have enacted legislation to validate the trust as a permissible form of business organization. These statutes came in four waves. Appendix A [omitted] collects the existing business trust legislation. [The four generations will be discussed here.]

The entity that arises under the fourth (and perhaps the third) generation business trust statutes is better understood as the "statutory business trust," "statutory trust entity," or "statutory trust" than as a perfection of the common law business trust. The Delaware-style, fourth generation statutory trust differs from a common law trust in several important respects.

A common law trust, whether its purpose is prevalingly donative or commercial, arises from private action. Because a common law trust is not a juridical entity, it must sue, be sued, and transact over property in the name of the trustee in the trustee's capacity as such. By contrast, a statutory trust is created by making a filing with a public official, typically the Secretary of State. Like a corporation, a statutory trust is deemed a juridical entity, separate from its trustees and beneficial owners, that has capacity to sue, be sued, and transact over property in its own name.

The Delaware-style statutes also represent the end-game in the march toward freedom of contract in business organization law. The Delaware act allows virtually unlimited freedom of contract in the design of the trust's capital structure and internal governance.⁹

⁹These statutes state that their underlying policy is "to give maximum effect to the principles of freedom of contract and to the enforceability of governing instruments." See Conn. Gen. Stat. §34-546; 12 Del. Code §3823(b); Nev. Rev. Stat. §88A.160; N. H. Rev. Stat. §293-B:1; S.D. Codified L. §47-14A-95; Va. Code §13.1-1282(B); Wyo. Stat. §17-23-302(b). See also 15 Pa. Con. St. §9502(e) (similar statement, third-generation statute)

B. Jurisdictional and Inter-Entity Competition

Based on data obtained from state registry offices [see omitted Appendix B], more SBTs are organized under the fourth-generation statutes than all others combined. Further, the data indicate that Delaware is the leading fourth-generation SBT jurisdiction. SBTs organized under the 1988 Delaware act outnumber all other fourth-generation SBTs combined by a factor of almost ten to one. Thus, as in corporate law, Delaware dominates the jurisdictional competition over SBTs.

The total number of SBTs is small, however, in comparison to the number of corporations and limited liability companies (LLCs). [Data will be presented with graphs and tables.] [Jurisdictional competition over SBTs must be an interest group story where transactional lawyers are the key players; there are no franchise taxes. Note the similarity to the competition for donative trusts.¹⁰]

III. STATUTORY BUSINESS TRUSTS IN PRACTICE

In practice the modern SBT is used primarily (1) as a special purpose vehicle in asset securitization transactions, and (2) for organizing mutual funds. [Most REITs are not trusts, contrary to the common assumption in the existing literature.]

Interestingly, in both the mutual fund and asset securitization industries the SBT issues passive equitable participation rights (akin to shares in a corporation) over asset pools or funds that operate in the shadow of federal bankruptcy, securities, and tax law. Indeed, the fourth-generation statutes contain a variety of provisions that were designed for the singular purpose of allowing asset securitization deals to obtain favorable bankruptcy and tax treatment and for mutual funds to have the maximum flexibility permitted under the federal securities laws.

On this account, the SBT represents an opportunistic and limited evolutionary development in the law of business entities. Thus far the SBT is little used for more than a malleable entity of convenience by the asset securitization and mutual fund industries. This claim is consistent with the otherwise puzzling observation that, despite there being over 10,000 Delaware SBTs with a combined value in the trillions of dollars, since its enactment in 1988 there has been only one reported state court decision that even cites the Delaware act.

IV. WHY NOT OPERATING ENTERPRISES?

Although used principally in asset securitization and mutual funds, nothing in the fourth-generation statutes expressly limits their use to those fields. On the contrary, the modern business trust statutes read like open-ended, generic corporation codes. In fact, the Delaware SBT law is even more permissive and enabling than its law of corporations

¹⁰See Robert H. Sitkoff & Max M. Schanzenbach, Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes, 115 Yale L.J. 356 (2005).

and LLCs. As Hansmann, Kraakman, and Squire have observed, "In theory, any entity that can be formed as a business corporation, an LLC, an LLP, or an LLLP could be formed instead as a statutory business trust."¹¹ The question thus arises, why has use of the SBT remained limited to its niches in asset securitization and mutual funds?

[This section will discuss various possibilities including: (1) continuing legal uncertainty; (2) transaction costs arising from mismatch between trust law default rules and the needs of operating enterprises; (3) the related phenomena of path dependency and network externalities; (4) agency costs in the provision of legal services; and (5) Hansmann's theory of public provision of corporate terms.]

[This section will also address the entity-rationalization literature.]

V. THE UNIFORM STATUTORY ENTITY ACT

The Uniform Statutory Trust Entity Act, now in draft form, validates the statutory trust as a permissible form of business organization.

In drafting the substantive provisions of the Uniform Statutory Trust Entity Act, the drafting committee was influenced primarily by the Delaware Statutory Trust Act and secondarily by the Connecticut Statutory Trust Act. In drafting the public filing and other provisions not unique to the statutory trust form, the drafting committee took the Uniform Limited Partnership Act (2001) as its starting point. For guidance on the common law of trusts, the drafting committee looked to the Uniform Trust Code (2000).

The Uniform Statutory Trust Entity Act is more like a generic corporate code or unincorporated entity law than the Uniform Trust Code. Like a corporation, limited liability company, and limited partnership, but unlike a common law trust, a statutory trust is a juridical entity that may conduct transactions in its own name separate from that of its fiduciary and its beneficial owners.

Although much of the Uniform Statutory Trust Entity Act reflects a reorganization and refinement of provisions found in the Delaware Statutory Trust Act, the Uniform Act contains several innovations including: (1) specification of rules that are not subject to override in the statutory trust's governing instrument; (2) exclusion of trusts with a prevaillingly donative purpose; (3) clearer guidance on the relationship of ordinary trust law to statutory trust entities; (4) clearer guidance on the relationship between the common law trust and statutory trust entities; and (5) systematic treatment of conversions, mergers, and dissolutions.

[This section will discuss the possible effect of the USTEPA and will reference the literature on uniform lawmaking.]

¹¹Hansmann, Kraakman, & Squire, *supra* ____, at 14.

CONCLUSION