

## Title

### Entity Shielding and Capital Lock-in: The Business Trust versus the Corporation

## Text

If not as a partnership, then how should an enterprise with multiple investor-owners whose property interests in the enterprise are to be transferable/tradable shares legally operate? As a trust or as a corporation? If entity shielding is the only concern, it should not make that much of a difference.

Since long before widespread enactment of general incorporation statutes (mid-19<sup>th</sup> century) the business trust had been shielding the underlying assets of ongoing large investor-owned enterprises from being taken individually by a co-owner and/or his creditors. This ring-fence function has come to be known as entity shielding, whether in the case of a trust (where the equitable property/ownership interests are transferable shares of beneficial interest) or in the case of a corporation (where the legal property/ownership interests are transferable shares of stock). The creditor of the co-owner of an ongoing enterprise may be able to grab the owner's legal or equitable interest *in the enterprise* itself, i.e., the shares, but not the enterprise's underlying assets. Those are "reserved" for the creditors *of the enterprise*. An ongoing, solvent enterprise with numerous co-owners could not practically function otherwise. If its plant, equipment, and inventory were vulnerable to being taken at any time by a co-owner and/or his creditors, the enterprise would lack the certain stability, duration, and cohesion necessary to be commercially viable. In other words, entity shielding helps "businesses hold their assets together." John Morley, *The Common Law Corporation: The Power of the Trust in Anglo-American Business History*, 116 Colum. L. Rev. 2145, 2167 (2016). The creditors *of the enterprise*, of course, still will have access to its underlying assets. Capital lock-in is an application of entity shielding, namely when the enterprise itself restricts such access. Entity shielding is not to be confused with limited liability, which insulates *the owners* of an enterprise from the contract and tort liabilities of the enterprise itself.

Entity shielding is by no means the exclusive domain of the corporation, which is a creature of statute. "An analog of entity shielding first appeared in the trust...[a creature of equity,]...in the late Middle Ages as a direct consequence of the division between legal and equitable title that characterizes the trust." Id at 2168-2169. Legal title to the entrusted property being in the trustee rather than in the debtor co-beneficiary, the creditor was foreclosed from reaching the entrusted property itself. Section 10 of the Statute of Frauds, enacted by Parliament in 1677, afforded a trust beneficiary's creditors access to the equitable interest, but not the underlying trust property itself. This is functionally entity shielding. "Although a trust had never been a legal entity, the doctrines of Chancery, as modified by...various statutes, ensured that the assets that legally belonged to a trustee were shielded from a beneficiary's creditors almost as though they belonged to a distinct entity." Id at 2170. Fraudulent conveyance legislation is not an insignificant statutory doctrinal modification, to be sure, but one that applies to corporation-transferees as well as trustee-transferees. Also, nowadays, entity-shielding would not be available even post-inception in the case of a trust settlor who had retained an equitable interest

in all the trust's principal. This is the case even when the trustee is independent, is vested with sole principal-invasion discretion, and there is no fraud in the fact pattern. See generally §5.3.3.1 of *Loring and Rounds: A Trustee's Handbook* (2023), the relevant portion of which section is accessible via this link to my 10/1/2022 JDSUPRA posting:

<https://www.jdsupra.com/legalnews/judge-alice-m-batchelder-endeavors-to-l-06897/>.

(Specifically in the posting's appendix)

Entity shielding is not to be confused with trust-entity doctrine, which is the subject of §8.15.77 of the Handbook. Section 8.15.77 is reproduced in the appendix immediately below. It goes without saying that entrusted assets are off-limits to the trustee's personal creditors. See §8.3.1 of the Handbook. The Handbook itself is available for purchase at <https://law-store.wolterskluwer.com/s/product/loring-rounds-trustees-hanbook-2023e/01t4R00000Ojr97QAB>.

## Appendix

**§8.15.77 *The Trust Entity Doctrine*** [from *Loring and Rounds: A Trustee's Handbook* (2023), available for purchase at <https://law-store.wolterskluwer.com/s/product/loring-rounds-trustees-hanbook-2023e/01t4R00000Ojr97QAB>.]

*The whole bundle of property, persons, rights, and duties makes up the trust.*<sup>1329</sup>

**The trust is being deemed an entity for certain purposes.** Under classic principles of trust law, a trust is a fiduciary relationship with respect to property, not a juristic person.<sup>1330</sup> As to the world, the trustee is the legal owner of the property.<sup>1331</sup> The beneficiaries, however, have equitable property rights incident to the relationship. In other words, trusts are not corporate-like entities.<sup>1332</sup> Having said that, for some purposes legislatures and courts are treating trusts as if they were.<sup>1333</sup> “Under the ‘trust entity’ theory ... [, for example,]... a testamentary trust is established and remains at the testator's domicile, thereby giving the domiciliary court in rem jurisdiction independent and apart from the presence of the trustee, the trust assets or the trust beneficiaries.”<sup>1334</sup> The Model Protection of Charitable Assets Act (2011) deems a trust to be a person for its purposes.<sup>1335</sup> For years the tax laws have deemed certain trusts to be entities for purposes of the income tax, a topic we take up in Chapter 10 of this handbook. In §7.3.1 of this handbook, we consider the trust entity doctrine in the context of contracts between the trustee and third parties. The trust entity doctrine in the context of the trustee's liability in tort to third parties is considered in §7.3.3 of this handbook. A trust created under the Uniform Statutory Trust Entity Act is intended to be a juridical entity, “separate from its trustees and beneficial owners, that has

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<sup>1329</sup>Bogert §1, n.29.

<sup>1330</sup>See *Portico Mgmt. Grp., LLC v. Harrison*, 202 Cal. App. 4th 464 (2011); *Jimenez v. Corr*, 764 S.E.2d 115 (Va. 2014) (“In contrast, an inter vivos trust is inseparable from the parties related to it, and the trust does not have a separate legal status.”).

<sup>1331</sup>See *Portico Mgmt. Grp., LLC v. Harrison*, 202 Cal. App. 4th 464 (2011).

<sup>1332</sup>See *Portico Mgmt. Grp., LLC v. Harrison*, 202 Cal. App. 4th 464 (2011).

<sup>1333</sup>See, e.g., *Nat'l Collegiate Student Loan Tr. 2007-3 v. Clayborn*, 850 S.E.2d 787 (Ga. 2020).

<sup>1334</sup>Bogert §292. See, e.g., *In re Black*, 2020 COA 64M (Colo. Ct. App. 2020). Judicial jurisdiction in the context of trusts is taken up generally in §8.40 of this handbook.

<sup>1335</sup>See Model Protection of Charitable Assets Act §2(3) (2011).

the capacity to sue and be sued, own property, and transact in its own name.”<sup>1336</sup> In some jurisdictions, a formal conveyance to, or registration in the name of, “the trust” rather than the trustee will nonetheless have the effect of lodging legal title to the subject property in the trustee. See generally §2.1.1 of this handbook. The federal courts will generally deem even a “common law” trust a “collective entity” when adjudicating availability of the Fifth Amendment privilege against self-incrimination. A trustee, for example, may not, at least via assertion of the privilege, avoid having to comply with a governmental request for trust-related documentation, the privilege protecting only natural persons.<sup>1337</sup>

**Entity shielding and capital lock-in: The business trust versus the corporation.** “Entity shielding” in the trust context is the subject of §8.34 of this handbook.

**To fundamentally transmogrify the trust into an entity, however, would be ill-advised.** While it may be convenient to *deem* a trust an entity *for certain purposes*, such as when it comes to the formal titling of entrusted assets, it would be ill-advised, legislatively or otherwise, to altogether revise the default law of trusts such that the trust is no longer fundamentally a relationship; rather, it is now fundamentally a juristic entity/person. The two classic fiduciary relationships are the agency and the trust. Just as a conversion of the agency into a juristic entity/person would self-evidently destroy the agency’s practical utility, so also would such a conversion of the trust into a juristic entity/person destroy the trust’s practical utility, particularly in the case of the informal trust. The corporation has already been invented. There is no need to reinvent it. That the legal title to the trust property is in the trustee, that the trustee as to the world is the owner of the property, that the entrusted assets are segregated from the trustee’s personal asset, and that the trustee assumes direct burdensome fiduciary duties to identifiable individuals or charitable purposes is what has made the trust such an attractive alternative to the corporation in certain settings, particularly in the informal, noncommercial setting. Even in the commercial context, the trust’s protean nature can make it an attractive alternative to the standardized corporation, particularly when structural flexibility and operational nimbleness are a priority.<sup>1</sup> And then there are the inevitable unanticipated/unintended consequences were the trust to be fundamentally transmogrified into a juristic entity/person. What, for example, would now be the legal/equitable status of the “trustee”? Would the “trustee” be an agent/ employee of “the trust”? Where would the legal title to the underlying property now be lodged? Still in the “trustee” or now in “the trust”? The rights, duties, and obligations of the “parties” to “the trust,” once a long-seasoned legal/equitable relationship, now a fledgling juristic entity/person, would take decades, if not centuries, to sort out.

**The business trust not deemed an entity for purposes of determining federal diversity-of-citizenship jurisdiction.**<sup>1338</sup> U.S. Supreme Court has held that a Maryland real estate investment

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<sup>1336</sup>Unif. Statutory Trust Entity Act, Prefatory Note.

<sup>1337</sup>See *United States v. Fridman*, 974 F.3d 163 (2d Cir. 2020).

<sup>1</sup> See generally §8.34 of this handbook (entity shielding and capital lock-in

<sup>1338</sup>“Adopting the Tenth Circuit’s reasoning [which the U.S. Supreme Court has done] would treat those REITs as citizens of every one of those states for purposes of federal diversity jurisdiction. That would largely deprive REITs of access to the federal courts sitting in diversity: they would be unable to remove actions to federal court based on diversity, 28 U.S.C. §1441(b)(2) (an action brought in state court in a state where a defendant is a citizen may not be removed to federal court based on diversity), and likely would not be able to establish even the minimal diversity required for removal of large class actions.” Brief for The National Association of Real Estate Investment Trusts as Amicus Curiae Supporting Reversal, p. 1–2, available at <http://www.scotusblog.com/wp->

trust (REIT) may not be deemed a “citizen” for purposes of determining federal diversity-of-citizenship jurisdiction, although Maryland statutory law treats a REIT as a “‘separate legal entity’ that itself can sue or be sued.”<sup>1339</sup> Nor is the citizenship of the trustee determinative, as would be the case with a “traditional trust.”<sup>1340</sup> The holding: For purposes of diversity jurisdiction, the citizenships of the REIT’s shareholders, not just the citizenships of the trustees, are taken into account.<sup>1341</sup> The REIT is defined in §9.9.12 of this handbook.

*Cross-reference.* See generally §3.5.1 of this handbook (nature and extent of the trustee’s estate).

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content/uploads/2015/12/14-1382\_amicus\_pet\_NAREIT.authcheckdam.pdf (last accessed Sept. 4, 2021), in *Americold Realty Tr. v. ConAgra Foods, Inc.*, 136 S. Ct. 1012 (2016).

<sup>1339</sup>*Americold Realty Tr. v. ConAgra Foods, Inc.*, 577 U.S. 378, 136 S. Ct. 1012 (2016).

<sup>1340</sup>*Americold Realty Tr. v. ConAgra Foods, Inc.*, 577 U.S. 378, 136 S. Ct. 1012 (2016).

<sup>1341</sup>*Americold Realty Tr. v. ConAgra Foods, Inc.*, 577 U.S. 378, 136 S. Ct. 1012 (2016).