



Corporate Transparency Act: Who Can Exert Substantial Influence on My Company? Part II

Dec 06, 2023

Categories:

[Corporate
Transparency Act
Publications](#)

Authors:

[Alan K. MacDonald](#)
[Asia B. Wright](#)
[Zachary D. Bahorik](#)

Part II: Assessing Sources of Substantial Influence Beyond Voting Power

The Corporate Transparency Act (CTA)^[i] was enacted to combat the use of multi-layered shell company structures to hide the identities of individuals engaging in various types of criminal activities, such as terrorism, drug trafficking, money laundering, and financial fraud. CTA responds to the U.S. government's inability to mandate the collection of beneficial ownership information of corporate entities formed in the U.S., which has been identified as a vulnerability in the U.S. enforcement framework by the Financial Crimes Enforcement Network, an agency of the U.S. Department of the Treasury known as "FinCEN."^[ii]

CTA requires companies subject to its reporting mandate to disclose beneficial ownership information (BOI) about two classes of natural persons who are affiliated with the reporting company.

- Individuals who exercise, directly or indirectly, "substantial control" over the reporting company; and
- Individuals who own or control, directly or indirectly, at least 25% of the "ownership interests" of the reporting control.

CTA imposes substantial penalties for violations, aiming to deter the use of shell companies to obfuscate the identities of the actors controlling the criminal enterprise.^[iii]

This series of articles examines the first two categories of beneficial owners.

Below, we analyze how and when some of the common techniques for allocating control of a business entity beyond voting power may constitute substantial control and trigger the BOI disclosure requirement.

Click [here](#) to read our first piece, where we look at the definition of Substantial Influence and discuss:

- Corporate Directors;
- Voting Power; and
- Exercise of Substantial Control

Techniques for Allocating Control Beyond Voting Power

Right to Board Representation. The BOI Regs provide that an individual with “authority over the appointment or removal of any senior officer or a majority of the board of directors (or similar body)” has substantial control. The BOI Regs also identify the right to Board representation as an indicator of substantial control.^[iv] What weight applies to the right to appoint a single director or a number of directors that would be less than a majority?

An investor who has sufficient leverage to negotiate for and obtain the contractual right to designate a director does so to directly influence the management of the entity. The individual who serves on a corporate board of directors assumes the risk of potential liability for breaches of the fiduciary duties of care and good faith to act in the best interests of the corporation and its shareholders. Those obligations are a serious consideration for an individual deciding whether to participate directly in the corporation’s strategic decision-making as a director.

The safest course would be to assume the individual who represents an investor on the board of directors will always have substantial influence and be identified as a beneficial owner. The individual who holds the contractual right to appoint the director, if different, will almost always be a beneficial owner as well. If an entity holds that right and is itself a reporting company, one must look upstream to identify one or more individuals or an exempt entity that controls the reporting company with the contractual right to board representation.

Board Observer Rights. A person who makes a substantial investment in a reporting company may demand contractual

observer rights instead of the right to appoint a director. The holder would then be entitled to designate a representative to attend board meetings in a non-voting capacity and receive the information provided to the directors in advance of each meeting. Thus, the rights holder obtains the informational benefit of board membership without the fiduciary duties and potential personal liabilities of a board position. Usually, the observer cannot receive information about, and cannot be present for, decisions about highly sensitive matters, such as personnel matters relating to senior personnel. Unless the holder of board observer rights has a significant ownership position or other contractual management rights that would separately cause the holder to be deemed a beneficial owner, board observer rights alone would not enable the holder to exert substantial influence.

Agreements Among Equity Owners. The various techniques for allocating control among the equity owners of a business organization are set forth in either its organizational documents or contracts that govern the entity's operation.

In a limited liability company, the relationship of the members, managers and the company is essentially governed by contract. The rights of the members and the other provisions allocating control are customarily set forth in a single agreement, called a limited liability company agreement or an operating agreement.

Likewise, in partnerships formed by a filing with the secretary of state, the relationship of the general partners, limited partners, and the partnership is prescribed by the partnership agreement.

Corporations, however, are created by statutes that impose more internal governance requirements than limited liability company and partnership statutes. Corporation statutes, articles of incorporation, and bylaws usually cover basic corporate mechanics and procedures, as well as shareholder rights and restrictions. However, shareholders often want to agree among themselves as to matters beyond the scope of the statutes and organization documents. Shareholder agreements used for this purpose are private agreements among some or all of the shareholders which govern the relationship among the shareholders party to the agreement. The corporation is frequently a party to the shareholder agreement

as well.

The existence of private agreements, written or oral, that cover matters of internal governance and control can create a dilemma for the senior officers responsible for BOI reporting. Assume an LLC agreement or shareholder agreement provides that the holders of a majority of the voting power must approve an annual budget. The BOI Regs state that the power to approve the annual budget signifies substantial control, but by whom? Must the reporting company construct a group of its equity holders who could hypothetically act in concert to approve or veto the budget and assume their ability to influence is “substantial?” How much latitude will the BOI Regs allow for the exercise of reasonable judgment by the senior officers of the reporting company?

Consent Rights. If the reporting company enters into an agreement with an investor that grants the investor the right to consent to one or more of the transactions specified in the BOI Regs, then it would be reasonable to conclude the counterparty can exert substantial influence, and report accordingly.[\[v\]](#) But what if the reporting company’s governing document or contract provides that a reporting company can enter into a material contract or undertake any other action only with the consent of the holders of a certain percentage of its equity interests, and no one person holds the required percentage?

In this situation, the senior officers of the reporting company face a similar dilemma to the voting power issues described in [Part I](#) of this series of articles. Must the reporting company define a group of its larger equity holders who could, if they chose to act in concert, approve or veto a transaction? If so, must the senior officers assume that each individual’s ability within the group to influence is “substantial?” How much latitude do the BOI Regs allow the senior officers to exercise reasonable judgment?

Distribution Priority. When a company has received one or more rounds of outside investment, the priority in which the various investors receive distributions and the amounts they receive will have been negotiated by the company and its investors and set forth in the governing documents. Generally, distributions will only be made when the company is generating cash flow beyond what is

needed to operate the business. The BOI Regs do not expressly classify decisions regarding the timing of and amounts available for distributions as “important decisions,” although those will likely have a more significant impact on the company’s finances than the amounts investors are entitled to receive and the distribution priority among the different classes of investors. In most cases, the decision-makers will be the board of directors, the managers, and senior management, all of whom will already be deemed to be beneficial owners.

Rights When Shareholders Exit the Company. When a shareholder wants to withdraw from a closely held company and be repaid the value of its ownership interest, the remaining owners have a strong interest in determining how and to whom the interest may be transferred. Prohibiting transfers altogether is generally unenforceable.

The governing documents or agreements usually address this situation by providing that the company may repurchase the interest, the remaining shareholders may purchase a pro rata portion of the interest, or a combination of the two. Typically, the company and/or its remaining owners must purchase no less than all of the exiting owner’s interests. If they fail to do so, the exiting owner can sell its interests to a third party on the same or no less favorable terms.

The most commonly used techniques for addressing owner exits are:

- Right of First Refusal prohibits the exiting owner from selling its interests to a third party without first giving the company or the other owners the right to buy those interests on the same terms and conditions offered by a third-party purchaser, in proportion to their ownership interests.
- Right of First Offer requires the exiting owner to offer its interests to the company and the other owners before offering it to a third party. For the exiting owner, it has the advantage of not having to first obtain a written offer from a third party.

- Put Right gives the owner the right, but not the obligation, under certain circumstances to sell its interests to the company or the other owners (in proportion to their ownership interest) at either a pre-agreed price determined by a formula set out in the governing agreement or a price to be determined by an independent third party.
- Call Right gives the company or one or more owners the right, but not the obligation, to buy the interests of another owner in certain specified circumstances. The call right is usually triggered by an owner's default under a governance agreement, insolvency, or termination of employment with the company.

None of these rights enables individual owners to exercise management rights that would rise to the level of substantial influence. The greater concern is that the exercise of the right could cause one or more of the owners to exceed the 25% ownership threshold, thus becoming a beneficial owner for reporting purposes and triggering the duty to promptly update the company's report. For example, if the company buys all of the exiting owner's interests, the ownership interests and voting power of each of the remaining owners will increase proportionately. Likewise, if one or more owners purchase their own allocations plus the allocations of nonparticipating owners, the company's beneficial ownership structure could be significantly altered. Purchases of an exiting owner's interests would also necessitate a reassessment of the ownership structure to determine whether there is a readily identifiable group of owners who have the collective voting power to exert substantial influence over management.

Rights to Maintain One's Ownership Interest. These give owners the right to buy a pro rata portion (based on their ownership interest) of any future offers by the company to purchase its ownership interests. It prevents the company from unilaterally issuing additional interests and diluting the ownership interest or reducing the percentage interest of the owners.

- Preemptive Right is generally a right granted to all owners in a governing document such as articles of incorporation or bylaws.

- “Gross-Up Right” is the term sometimes used for a contractual right granted to individual investors to purchase a pro rata portion of the offered interests as long as those investors continue to hold a certain ownership percentage, such as five or ten percent.

The impact on beneficial ownership would depend on the extent to which owners exercise their rights to purchase interests in the company’s offering. If all the owners have rights and purchase their pro rata allocation, beneficial ownership would not change. Assuming that fewer than all of the company’s owners purchase their allocation, and that the company is able to sell the unpurchased interests, the purchasing owners would maintain their relative ownership position and any nonparticipants would be diluted. In addition, if the company sells a significant volume of new interests, it could create new owners with substantial economic rights or voting power, which would have to be assessed for reporting purposes.

Rights in Connection with the Sale of the Company.

- Drag-Along Right grants an owner or group of owners holding a majority of the interests who plan to sell all of its interests to a third-party acquiror the right to force the other owners to also sell all of their interests to that third party. A drag-along right facilitates the sale by allowing the acquiror to avoid inheriting minority owners who have rights the acquiror must honor or whom the acquiror must buy out.

A question of substantial control arises when no single owner holds 25% of the interests, but several persons hold significant ownership positions. Must the reporting company assume that this group of equity holders could hypothetically band together to force the sale of the company, and therefore each of them possesses the ability to “substantially” influence the company’s strategic direction? How much latitude will the BOI Regs allow for the exercise of reasonable judgment by the senior officers of the reporting company?

- Tag Along Right, also known as a co-sale provision, protects minority owners by giving them the right to participate on a pro rata basis in any sale of ownership interests to a third-

party purchaser by owners of a majority of the company's interests. The existence of a tag-along right by itself would not give any owner the capacity to exert substantial influence over the company's strategic direction.

Conclusion

For a company that is not exempt from CTA reporting, the identification of beneficial owners can involve difficult judgment calls when the company's equity owners have contractual voting and governance rights. The BOI Regs offer little guidance as to the latitude the reporting company's senior officers will have to exercise reasonable judgment, and the penalties for mistaken assumptions can be severe. Seeking the advice of legal counsel in making difficult decisions about the degree of investor influence may be a factor in reducing the risk of a penalty if the senior officers' judgment is subsequently questioned.

For more information, contact any attorney with Frost Brown Todd's [Corporate Law](#) practice group.

Frost Brown Todd's Corporate Transparency Act Team is staying up to date on the important rule changes that will likely have significant impacts on your business operations. Click below to read the latest information about the Corporate Transparency Act.

- [**Corporate Transparency Act: Who Can Exert Substantial Influence on My Company? Part I**](#)
- [**Reporting Under the Corporate Transparency Act – Is My Company Exempt?**](#)
- [**FinCEN Announces Proposed Solution to Disclosure Dilemma in the Corporate Transparency Act**](#)
- [**Portfolio Company Reporting Under the Corporate Transparency Act**](#)
- [**The Corporate Transparency Act: Considerations for Effectively Using the FinCEN Identifier**](#)
- [**The Corporate Transparency Act's Impact on the Real Estate Industry: What You Need to Know to Comply**](#)

- **[The Corporate Transparency Act: Targeting Shell Companies for Money Laundering and Financial Crimes](#)**
- **[Transparency Enters A New Stage – Defense Act Anti-Laundering Provisions Now in Place](#)**

[Subscribe to Get CTA Updates](#)

[i] 31 U.S.C. § 5336, enacted as part of the National Defense Authorization Act for Fiscal Year 2021.

[ii] Beneficial Ownership Information Reporting Requirements, Adopting Release 87 FR 59498 (Sept. 30, 2022) (“Adopting Release”).

[iii] Any person who willfully provides false information to FinCEN, or willfully fails to report information to FinCEN as required: (i) will be liable for a civil penalty of not more than \$500 for each day that the violation continues or has not been remedied; and (ii) may be fined not more than \$10,000, imprisoned for not more than two years, or both. 31 U.S.C. § 5336(h).

In addition, the BOI Reg provides: It shall be unlawful for any person to willfully provide, or attempt to provide, false or fraudulent beneficial ownership information, including a false or fraudulent identifying photograph or document, to FinCEN in accordance with this section, or to willfully fail to report complete or updated beneficial ownership information to FinCEN in accordance with this section. 31 C.F.R. § 1010.380(g).

[iv] 31 C.F.R. § 1010.380(d)(1)(i)(B)

[v] Decisions about the following matters are considered “important decisions,” although the list is not exclusive:

- The nature, scope, and attributes of the business of the reporting company, including the sale, lease, mortgage, or other transfer of any principal assets of the reporting company;
- The reorganization, dissolution, or merger of the reporting company;
- Major expenditures or investments, issuances of any equity, incurrence of any significant debt, or approval of the operating budget of the reporting company;

- The selection or termination of business lines or ventures, or geographic focus, of the reporting company;
- Compensation schemes and incentive programs for senior officers;
- The entry into or termination, or the fulfillment or non-fulfillment, of significant contracts;
- Amendments of any substantial governance documents of the reporting company, including the articles of incorporation or similar formation documents, bylaws, and significant policies or procedures.

31 C.F.R. § 1010.380(d)(1)(i)(C).

Akin to the “important decisions” identified in the BOI Regs, Section 3.3 of the National Venture Capital Association’s model Certificate of Incorporation (available at [Model Legal Documents – National Venture Capital Association – NVCA](#)) includes “preferred stock protective provisions” requiring the consent of a majority of the preferred shares to take certain actions, including the following:

- Increase or decrease authorized shares;
- Create different classes of stock and assign voting rights;
- Issue dividends and/or redeem stock
- Sell or license material assets;
- Liquidate or dissolve; or
- Change the makeup of the board of directors.

© 2026 FBT Gibbons LLP. May be considered attorney advertising in some jurisdictions.