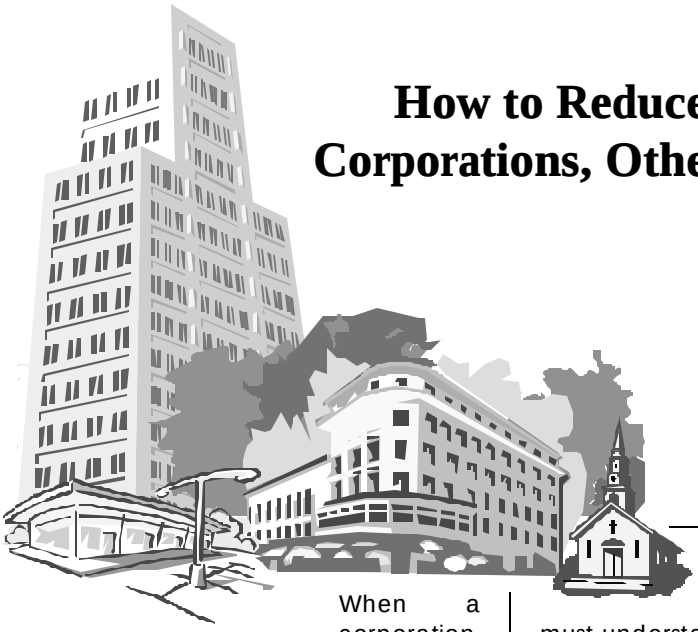
Know Your Entity:

How to Reduce Risks When Insuring Titles Granted by Corporations, Other Legal Entities, Trustees, and Churches *(Part One)*

James Bruce Davis[1], Esq.,
Daryl S. Taylor, Esq., and Lisa J. Tomasetti, Esq.
Bean, Kinney & Korman, PC
Arlington, VA



When a corporation, partnership or other legal entity sells or mortgages property, title insurers require evidence of the entity's legal existence, its capacity to enter into the transaction, and the authority of its officers, partners, or members to execute the transaction documents. The reason for these requirements is that title insurance protects the new owner or lender against the risks that the grantor or borrower did nor exist, that it lacked the capacity to grant an interest in property, or that its officers partners or members acted without authority.[2]

The 1996 case of *FDIC v. Hish*,[3] illustrates some of the title risks that arise in transactions involving legal entities. The title insurance policy in *Hish* covered a $1.8 million deed of trust executed in the name of a dissolved partnership by on of its general partners, as "Trustee in Dissolution." Unfortunately for the lender and title insurer, dissolved partnerships do not have "trustees in dissolution." Instead, title to a dissolved partnership's property remains in the partnership until its affairs are wound up. Although the person who signed the deed of trust actually was a general partner in the partnership, he obtained the mortgage loan for his own purposes, not for a partnership purpose. After years of litigation, the title insurer paid a substantial loss.

To reduce the risk of such losses, title insurance professionals, title insurance professionals must understand entities and exercise due diligence in transactions involving them. This article will survey Virginia law regarding legal entities and suggest various ways to confirm an entity's existence, ascertain its capacity to deal with real estate, and verify that the entity has authorized a transaction. The entities considered include corporations, partnerships, limited partnerships, and limited liability companies.

This article also will consider special authority issues concerning trustees and churches. Although a trustee may be an individual rater than a legal entity, anyone dealing with a trustee is on inquiry regarding the trustee's authority, unless that authority is set forth in a recorded deed to the trustee that meets the requirements of the Virginia Land Trust Statute.[4] Separate Virginia statures require churches to hold title to property through court-appointed trustees, and require those trustees to obtain court approval before selling or encumbering church property.

Corporations

A corporation has no legal existence until it is created under a state's corporation laws, or, in some cases, by a charter from the federal government (*e.g.* national banks). Under the Virginia Code, a corporation has no existence until the estate Corporation Commission (SCC) issues a certificate of incorporation.[5] To obtain a certificate of incorporation, the persons seeding to form a corporation ("incorporators") must file articles of incorporation with the SCC and pay all required filing fees.

A corporation may exist indefinitely, however, its existence may terminate in several ways. A corporation may terminate its own existence voluntarily at any time by filing articles of termination with the SCC.[6] A corporation's existence terminates automatically if the corporation fails to comply with certain legal requirements, such as failing to file an annual report or failing to pay an annual registration fee.[7] Also, the SCC may enter an order terminating a corporation's existence if the corporation fails to abide by the laws and requirements of Virginia corporations.[8] After a corporation's certificate of incorporation has been revoked, the corporation ceases to exist. However, a corporation may revive its charter within five years after a termination by making application with the SCC and coming in to compliance with the Virginia Code, unless the SCC revoked the corporation's charter for abuse of authority.[9]

If a corporation's charter has been revoked, and has not been revived, then the former corporation has no legal existence, and it lacks the capacity to sell or mortgage property. When a corporation ceases to exist, title to its assets passes by operation of law to the corporation's directors a "trustees in liquida-

tion."[10] The disposition of a former corporation's property by trustees in liquidation is beyond the scope of this article. If asked to insure a sale or encumbrance by a corporation's trustee in liquidation, a title insurance agent should refer the mater to the title insurer's underwriting counsel.

Title insurers usually verify a Virginia corporation's existence by obtaining a recent certificate of good standing from the SCC. As long as a corporation exists, it has the legal capacity to own and encumber real estate, unless some provision of the corporation's articles of incorporation or bylaws prohibits is from doing so. Some title insurers review a corporation's articles of incorporation and by laws to assure that neither of these documents limits the corporation's authority to own real estate.

In addition to verifying a corporation's existence and its capacity to enter into real estate transactions, title insurers verify that the corporation has authorized a proposed sale or encumbrance of this property. Proof of the corporation's authority usually takes the form of a certificate of corporate resolution, signed by the corporation's secretary, certifying that the corporation's board of director: 1) authorized the proposed sale or encumbrance of the corporation's property in accordance with the corporation's bylaws; and 2) directed on of the corporation's officers or employees, usually a president or a vice-president, to execute an deliver the deed or deed of trust on behalf of the corporation. Ideally, the corporate secretary also will provide a certificate of incumbency, identifying the corporation's offices and providing exemplars of their signatures. The certificate of incumbency may be combined with the certificate of corporate resolution.

A corporation conveys or mortgages property by having one or more of its officers or employees execute a deed or a deed of trust on behalf of the corporation. The person who signs an instrument must be one of the persons authorized to do so by the board of directors' resolution.

When a foreign (*i.e.* non-Virginia) corporation sells or mortgage property, title insurers normally verify the corporation's existence by obtaining a current certificate of good standing from the corporation's state of incorporation. Although the Virginia Code requires foreign corporations transacting business in Virginia to obtain a certificate of authori8ty from the SCC, owning property, without more, does not constitute transaction business for purposes of the statue, or does acquiring or enforcing mortgage loans.[11] More important, a foreign corporation's failure to qualify to transact business in Virginia does not prevent the foreign corporation from conveying or mortgaging Virginia property. [12]

To verify that a foreign corporation as authorized a particular transaction title insurers should exercise the same due diligence as with a Virginia corporation.

Partnerships

Partnerships come in several varieties. The oldest kind of partnership, a general partnership, is "an association of two or more persons carrying on business for profit."[13] A general partnership has only one kind of partner, and the partners in a general partnership are jointly and severally liable for the partnership's obligations (unless the partnership has registered as a "registered limited liability partnership," as will be discussed below).[14] General partnerships are governed by Virginia's Uniform Partnership Act. [15]

Another kind of partnership, known as a limited partnership, has two kinds of partners: general partners, who manage the partnership's business and who are liable for its obligations; and limited partners, who have no authority to manage the partnership's business and whose liability for partnership obligations is limited to their investment in the partnership. Limited partnerships are governed by Virginia's Revised Uniform Limited Partnership Act. [16]

The most recent kind of partnership is the registered limited liability partnership. A registered limited liability partnership is either a general partnership or a limited partnership that has registered with the SCC for the purpose of limiting its general partners' liability for the partnership's obligations. Like limited partners in a limited partnership, the general partners in a registered limited liability partnership have no liability for the partnership's debts beyond their investment in the partnership. [17]

General Partnerships

A general partnership is alegal entity separate and distinct from its partners.[18] Therefore, title insurers should verify that a general partnership exists prior to insuring a deed or deed of trust granted by a general partnership.[19]

General partnerships usually are created by contract or agreement, although the contract need not take any particular form, and need not be in writing.[20] Because unwritten agreements are difficult to prove, a written partnership agreement constitutes the only practical way to prove the existence of a general partnership. Therefore, commitments for title insurance normally require any general partnership that is conveying an interest in property to provide a copy of its written partnership agreement.

Prior to July 1, 1997, a general partnership was required to file a partnership certificate with the office of the clerk in which deed are recorded in the county where the partnership conducted its business.[21] Because the Virginia Code was unclear as to what consequences might flow from failing to file a partnership certificate, title insurers usually required a partnership grantor or mortgagor to comply with the filing requirement.

However, under Virginia's Uniform Partnership Act, which took effect on July 1, 1997, no filing is required to create a general partnership. The Act allows, but does not require, a general partnership or its partners to file various kinds of "statements" with the SCC – statements of partnership authority,[22] statements of denial[23] and statements of dissociation.[24] The effect of these statements will be discussed below.

After a partnership has been formed, it continues to exist until the partnership dissolves and thereafter "winds up" its business.[25] "Dissolution" of a partnership does not terminate the partnership's existence. Instead, dissolution marks the beginning of a process in which the partnership "winds up" its affairs, leading to the partnership's termination. After dissolution, the partnership may not engage in new business transactions, but may engage in transactions necessary for the wind-up, such as selling assets, paying debts, and, after all debts have been paid, distributing any remaining assets to partners. The partnership's existence continues after dissolution and terminates only upon the completion of the wind-up.[26] Therefore, a dissolved partnership has the legal capacity to convey or mortgage its property as appropriate for winding up its business. [27]

After determining that a general partnership exists, the title insurer's next task is to verify that the partnership has authorized the transaction that the title insurance company has been asked to insure. To make this determination, title insurers must examine the partnership agreement for three purposes: 1) to verify the identity of the partners in the partnership; 2) to determine whether the partnership agreement authorizes the partnership to enter in to the kind of transaction contemplated; and 3) to verify that the partnership has taken all necessary internal action authorize the transaction (*e.g.* obtaining partner consents).

The conventional way to confirm that a partnership has authorized a transaction is to require all of the partners to sign the deed or other instrument affecting title. An alternative is to require all of the general partners to execute a partnership resolution that authorizes one or more of the partners to sign the deed or other instrument on behalf of the partnership. However, obtaining all partner signatures I not necessarily a legal requirement. Unless a statement of partnership authority filed with the SCC provides otherwise, any single partner of a general partnership is the partnership's agent for the purpose of transacting the partnership's business.[28] A partner's execution of a deed or other legal instrument, in the partnership's name, for "apparently carrying on in the ordinary course the partnership business or business of the kind carried on by the partnership" is binding on the partnership unless the partner had no authority to act for the partnership and the person with whom the partner was dealing knew or had received notification of the partner's leak of authority. [29]

However, a partner's act that does not appear to be in the ordinary course of the partnership's business, or the kind of business that the partnership carries on, does not bind the partnership unless the act was authorized by the other partners.[30] A partner has no authority to use partnership property for his own personal benefit unless all of the partners consent.[31] Therefore when fewer than all of the partners sign an instrument affecting title, title insurers must be especially alert for warning sings of self dealing or other circumstances that could affect the validity of the transaction. The warning signs include: 1) an unexplained or unreasonable reluctance by the partnership to obtain a resolution of the partners authorizing a transaction 2) known disputes among the partners, or 3) the use of the proceeds of a sale or financing by the partnership for purposes other than the partnership's business. An alarm should sound in the mind of a title insurance professional whenever a partner who enters a transaction on behalf of a partnership asks for the settlement proceeds to be paid to him, or for his benefit, instead of the benefit of the partnership.

Virginia's Uniform Partnership Act was completely rewritten, effective July 1, 1997, bringing about changes in partnership law that require title insurers to exercise even greater diligence when less than all partners sign a conveyancing document on behalf of a general partnership. As mentioned above, the Act permits a general partnership to file a "statement of partnership authority" with the SCC. [32] The Act provides also that, upon the filing of a statement of partnership authority, the public is deemed to be on notice of any provision in the statement that limits a partner's authority to transfer title to real estate held in the name of the partnership.[33] Therefore, when less than all of the partners in a general partnership sign a legal document, title insurers should review any statement of partnership authority on file with the SCC to make sure that a partner who proposes to sign a deed or deed of trust would not be violating any limitation contained in the statement of partnership authority.

The Act also permits a person to file a "statement of denial" that a partnership exists or that he is a partner in an existing partnership.[34] A statement of denial filed with the SCC puts the public on notice that the person who filed the statement denial has no authority to transfer or mortgage real estate held in the name of the partnership.[35]

A partner's authority to enter transactions on behalf of a general partnership may also be terminated if the partner dissociates fro the partnership. Under the Act, a dissociated partner or the remaining partners in a general partnership may file a "statement of dissociation" with the SCC.[36] The statement of dissociation puts the public on notice that the dissociate partner is no longer a partner in the partnership. The notice takes effect immediately as to anyone who actually know about the dissociation or, if a person does not have actual knowledge of the dissociation. Ninety days after the statement of dissociation was filed.[37] To protect against the risk that a partner purporting to act for a general partnership has dissociated from the partnership, title insurers should make sure that no statement of dissociation has been filed with the SCC.

To summarize, the best practice when dealing with a general partnership is t require all of the general partners to execute any instrument affecting g title to the partnership's real estate. An alternative method for assuring that a partnership transaction has been authorized is to require all of the partners to sign a resolution or consent authorizing one of the partners to sign the deed or deed of trust on the partnership's behalf. Proceeding without the unanimous writ-

ten consent of the partners exposes anyone dealing with the partnership to an increased risk that the transaction is unauthorized. Therefore, title insurers should consider proceeding without the consent of all partners only if there is a compelling reason to do so and if: 1) the partner entering into the transaction on behalf of the partnership is acting within the scope of his authority under the partnership agreement; 2) no statement of partnership authority, statement of denial or statement of dissociation on file with the SCC limits the partner's authority to bind the partnership; and 3) the transaction clearly is in furtherance of the partnership's business.

Next Issue…

- **Limited Partnerships**
- **Limited Liability Partnerships**
- **Limited LiabilityCorporations**
- **Trusts**
- **Churches**

[1] James Bruce Davis is a shareholder in Bean, Kinney & Korman, P.C., Arlington, VA. His practice focuses on title insurance claims and commercial litigation. Daryl S. Taylor is an associate attorney working in the commercial transactions department of Bean, Kinney & Korman, P.C. Lisa J. Tomasetti is an associate attorney working in the corporate department of Shaw, Pittman, Potts & Trowbridge, Tyson's Corner, VA. The authors appreciate Ashley Flynn's assistance in reviewing drafts of this article.

[2] Insuring clause 1 of the standard ALTA loan and owner's policy insures against the risk that title is vested in someone other than the insured owner. This clause would come into play if the entity that sold the land to the insured owner lacked authority to do so. Similarly, insuring clause 5 of the standard ALTA loan policy covers the validity or enforceability of the insured mortgage upon the title. This clause would come into play if the mortgagor lacked authority to mortgage the property.

[3] 76 F.3d 620 (4th Cir. 1996) (applying Virginia partnership law).

[4] VA. CODE ANN. §55-17.1 (Michie 1995).

[5] VA. CODE ANN. §13.1-621 (Michie 1999).

[6] VA. CODE ANN. §13.1-750 (Michie 1999).

[7] VA. CODE ANN. §13.1-752 (Michie 1999).

[8] VA. CODE ANN. §13.1-753 (Michie 1999).

[9] VA. CODE ANN. §13.1-754 (Michie 1999).

[10] §13.1-752(B)(2).

[11] VA. CODE ANN. §13.1-757 (Michie 1999)

[12] See, VA. CODE ANN. §13.1-758.E. (Michie 1999)(failure of a foreign corporation to obtain a certificate of authority does not impair the validity of its corporation acts…").

[13] VA. CODE ANN. §50-73.79 (Michie 1998) provides, in relevant part: "Partnership means an association of two or more persons to carry on an co-owners a business for profit formed under §50-73.88, predecessor law, or comparable law of another jurisdiction, and includes, for all purposes of the laws of this Commonwealth, a registered limited liability partnership.

[14] VA. Code Ann. §50-73.96 (Michie 1999).

[15] VA. Code ANN. §50-73.79, *et seq.* (Michie 1999).

[16] VA. Code Ann. §50-73.1 *et seq.* (Michie 1999).

[17] VA. Code ANN. §50-73.96(C) (Michie 1998).

[18] VA. Code ANN. §50-730.87 (Michie 1999).

[19] Prior to the existence of a partnership, a firm partner has no power to bind the firm. A partner's authority to bind a partnership only arises when the partnership actually exists and then only in matters necessary to the partnership's ordinary business. For instance, where a member of a prospective firm applies to a bank for a loan to make up his input in the capital stock, the firm's credit is not pledged, unless he was specifically authorized to bind the firm, or unless the action was subsequently ratified by them. *National Bank v. Cringan,* 91 Va. 347, 21 S.E. 820 (1895).

[20] VA. Code ANN. §50-73.88 (Michie 1998) provides, in part:

> A. Except as otherwise provided in subsection B. the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership.

Subsection B of the statue pertains to limited partnership. Subsection C sets out rules for determining when a partnership has been created.

See, *Persinger & Co. v. Larrowe,* 252 Va. 404, 477 S.E.2d 506 (1996) (no written document required to create a partnership); *Woodson v. Gilmer,* 205 Va. 487, 137 S.E.2d 891 (1964 (partnership relations are grounded upon contract, express or implied).

[21] Former Virginia Code §50-74 (repealed July 1, 1997, provided, among other things, that:

> (a) No two or more persons shall carry on business as partners unless they sign and acknowledge a certificate setting forth the full names of each person composing the partnership, with their respective post-office and residence addresses, the name and style of the firm, the length of time for which it is to continue, and the locality of their place of business, and file the same in the office of the clerk of the court in which deeds are recorded in the county or corporation wherein the business is to be conducted.

[22] VA. CODE ANN. §50-73.93 (Michie 1998).

[23] VA. CODE ANN. §50-73.94 (Michie 1998).

[24] Va. CODE ANN. §50-73.115 (Michie 1998).

[25] Va. CODE ANN. §50-73.118 (Michie 1998) provides in part:

> A. Subject to subsection B, a partnership continues after dissolution only for the purpose of winding up its business. The partnership is terminated when the winding up of its business is completed.

[26] *Id.*

[27] VA. CODE ANN. §50-73.120 (Michie 1998) provides:

> Subject to §50-73.21, a partnership is bound by a partner's acts after dissolution that:
>
> 1. Is appropriate for winding up the partnership business; or
> 2. Would have bound the partnership under §50-73.91 before dissolution, if the other party to the transaction did not have notice of the dissolution.

[28] VA. CODE ANN. §50-73.91 (Michie 1998); see, *Holloway v. Smith,* 197 Va. 334, 88 S.E.2d 909 (1955); *Ward v. Matter,* 41 Va. (2 Rob.) 536 (1843).

[29] VA. Code ANN. §50-73.91.1 (Michie 1998).

[30] *Id.*

[31] *FDIC v. Hish*, 76 F.3d 620 (4th Cir. 1966); *Cringan*, 91 Va. At 347, 21 S.E. at 820. VA. Code ANN. §50-73.100(G) (Michie 1998) states: "A partner may use or possess partnership property only on behalf of the partnership."

[32] Va. CODE ANN. §50-73.94 (E) (Michie 1998).

[33] VA. CODE ANN. §50-73.93 (E) (Michie 1998).

[34] VA. Code ANN. §50-73.94 (E) (Michie 1998).

[35] *Id.* Section 50-73.94 provides that a statement of denial has the same effect as a limitation of authority continued in a statement of partnership authority filed with the State Corporation Commission

[36] VA. Code ANN. §50-73.115 (Michie 1998).

[37] *Id.* 5814k4111k.,***V***