

UPDATE

News of Developments in the Financial Sector and Related Areas

*** IN THIS ISSUE ***

Application of Securities Laws to Interests in Limited Liability Companies

Regulation of National Banks by States

Newsletter Topics

Application of Securities Law to Interests in Limited Liability Companies

In recent years there has been a significant interest in the formation of limited liability companies, which are generally referred to as "LLCs." The LLC is a business entity that has the characteristics of both partnerships and corporations by combining the corporate advantage of limited liability with the income and losses being passed through to the owners, meaning that the LLC is taxed like a partnership or S corporation. Since the LLC is not taxed as a separate entity, the income and losses are reported on the tax returns of the owners. A LLC is owned by its members and does not have any restrictions on the number of members it can have. The members of a LLC are similar to partners in a partnership or shareholders in a corporation. Members of a LLC have the same limited personal liability provided to shareholders of a corporation. A member of a LLC will resemble shareholders in a corporation if the LLC utilizes a manager, since the members will not participate in the management of the LLC. However, if the LLC does not utilize a manager, then the members will be similar to partners in a partnership, since they will have a direct voice in the decisions made by the LLC. Some state securities regulatory agencies have taken the position that a

membership interest in an LLC is not a security if certain requirements are met, such as the following:

- the articles of organization of the LLC does not vest management of the LLC in one or more managers; and
- the aggregate number of members of the LLC does not exceed a specific number.

Similarly, state securities regulatory agencies have taken the position that a membership interest in the LLC is a security in situations such as the following:

- the articles of organization of the LLC or the operating agreement of the LLC delegates the essential managerial responsibilities to one or more managers who are not members; or
- the aggregate number of members of the LLC exceeds a specified number.

Robinson v. Glynn, Docket No. 03-1106, is a recent decision by the Fourth Circuit United States Court of Appeals which holds that a membership interest is not a security under federal law based on the facts in the case. In this case, James Robinson initially invested \$15 million in a limited liability company which was formed by Thomas Glynn to develop and market a telecommunication system Glynn had designed. When Robinson learned that Glynn had misled him about the testing of the technical viability of the system, he filed a lawsuit under federal law alleging misrepresentations under federal securities laws. The Fourth Circuit Court of Appeals upheld a lower federal court decision which had granted summary judgment in favor of Glynn, holding that the interest purchased by

Robinson was not a security under federal law. In its decision, the Court held that federal securities laws did not cover the interest purchased by Robinson because even though he had little technical knowledge, he had management rights in the LLC, served as a board member and on the executive committee and was vice chairman and treasurer of the LLC. The Court found that Robinson was a savvy and experienced businessman who had negotiated for management rights and actively exercised those rights and could not rely on his lack of technical sophistication in bringing his claim under federal securities laws. Based on the findings of the Court in this case, the outcome would have been different if Robinson had been merely a passive investor and had not maintained and exercised his management rights in the LLC. It is likely that the controversy over whether or not an interest in a LLC is a security subject to the protection of state and federal securities laws will continue based on factual situations that occur in the formation and operation of LLCs such as if a passive member is dependent upon the efforts of others.

Regulation of National Banks by States

In January, the Office of the Comptroller of Currency ("OCC") issued two final regulations relating to the preemption of state laws by federal law over national banks. The first regulation clarifies to the extent the operations of a national bank are subject to state laws and identifies the type of state laws that are preempted by federal law under the National Bank Act. The second regulation is directed toward the exclusive authority of the OCC under the National Bank Act to examine, supervise and regulate the affairs of a national bank. These two final regulations are a result of Advisory Letter 2002-9 which reflects the position of the OCC that it has exclusive authority over national banks and a later proposal by the OCC, Docket No. 03-16 clarifying the authority of the OCC over national banks. Although the earlier position

taken by the OCC had obtained support from trade groups, such as the American Bankers Association, the position by the OCC had been criticized by groups such as the National Association of Attorneys General and Paul Sarbanes of Maryland, the ranking Democrat on the Senate Banking Committee. In a recent letter to Paul Sarbanes from John Hawke, the Comptroller of the Currency, Mr. Hawke states, among other things, that the OCC does not assert that national banks are immune from state law and does not contend that certain state laws are preempted. The OCC's final regulations do allow courts to require national banks to produce witnesses or information, however the exception for courts does not permit a state authority to inspect, regulate or supervise national banks. In connection with the preemption final rule, the OCC has issued a series of questions and answers identifying the types of state laws that are preempted by federal law, and in connection with the visitorial powers final rule, the OCC has also issued questions and answers clarifying the right of a state authority to examine, supervise or regulate the affairs of a national bank. The letter to Paul Sarbanes from the OCC and the questions and answers on both of the final regulations are available on the web site of the OCC at www.occ.treas.gov. Because of the controversial nature of these two final regulations as to state versus federal regulation of national banks, we will probably see litigation from state regulatory authorities regarding the position taken by the OCC as reflected in these two final regulations.

Newsletter Topics

Topics to be covered in future newsletters will include Letters of Intent, sometimes referred to as Memorandums of Understanding, and the Customer Identification Rule issued under the USA Patriot Act. Persons may request topics for future newsletters by forwarding their request on the *Update* web site at www.GWBinns.com.