

# NEWS



# BUSINESS LAW

## LETTER

### MSBA SECTION OF BUSINESS LAW

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## Message from the Editors

**D**ear Members:

We hope that this issue of the Business Law Section Newsletter finds you well. Although our country is currently experiencing the worst financial crisis in decades, a condition that has not left our profession unscathed, please know that the members of the Business Law Section Council are hard at work on matters that are important to you and your practice. This year, we will be working to address legislation that enhances our corporate laws, to increase our role on the MSBA Board of Governors, to expand our continuing legal education offerings and methods of delivery (be it via live seminar, teleconference, or webinar), and to expand the capabilities of our website. Much is in store this year and if you are interested in joining a committee or increasing your role in the Business Law Section, please see the Section Council Roster included in this Newsletter for the contact information of Council Members and committee leadership.

We hope you enjoy this issue of our Newsletter and that you will consider submitting articles for publication with us in the future.

Happy Holidays.

*Joseph P. Ward*

*Jay G. Merwin, Jr.*

SECTION OF BUSINESS LAW NEWSLETTER  
Maryland State Bar Association

Submissions, questions, comments?

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# Don't Stray Too Far: When a Finder Becomes a Broker

By Lara L. Hjortsberg, Esq.

Being a transactional attorney, it is common to come across individuals and companies that characterize themselves as finders or business brokers. They reason that since they are “only finders,” they do not need to register as brokers under the federal securities laws. The problem is, this assumption is not necessarily true. This article seeks to provide an explanation of when finders step into dangerous territory and become brokers requiring registration under federal securities laws.

## Definition of Broker under the 1934 Act

Section 3(a)(4)(A) of the Securities Exchange Act of 1934 (the “1934 Act”) defines a broker as “any person engaged in the business of effecting transactions in securities for the account of others.” A finder cannot escape categorization as a broker by designating itself as a “finder” or a “business broker” and its compensation a “finder’s fee.” Rather, the SEC has taken a substance-over-form approach in its No-Action Letters with respect to broker registration and looks at the activities the finder performs and the basis for its compensation.

In recent years, the SEC has expanded the definition of broker by expressly limiting permissible finder activities. Most notable in this regard is the SEC’s 2000 *Dominion Resources, Inc.* No-Action Letter, in which the SEC withdrew its 1985 *Dominion Resources* No-Action Letter.<sup>1</sup> The 1985 letter had allowed a variety of activities in which a finder could participate without fear of being characterized as a broker, including analyzing the financial needs of an issuer, recommending or designing financing methods and securities to fit the issuer’s needs, recommending the lawyers to prepare documentation and underwriters and broker-dealers to distribute the securities, participating in negotiations and introducing the issuer to a commercial bank to act as the initial purchaser and as a standby purchaser if the securities could not be readily marketed. Now the SEC’s *Guide to Broker-Dealer Registration* and the *Broker-Dealer Report* make it quite clear that anything beyond “finding” can throw a finder squarely into the definition of a broker.

Many a finder has argued that he is not a broker because he did not “effect” a transaction in securities. The SEC has roundly rejected this argument, reading “effecting” in the definition of a broker ever more broadly to include all actions beyond introducing the parties in a securities transaction.<sup>2</sup>

The SEC has stated that finders that: (1) find investors for issuers, even in a consultant capacity; (2) engage, or find investors for, venture capital or angel financings, including private placements; or (3) find buyers and sellers of businesses (i.e., activities relating to mergers and acquisitions where securities are involved) may need to register as a broker, depending on a number of factors. These factors include: (1) whether the finder participates in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction; and (2) whether the finder’s compensation for participation in the transaction depends upon, or is related to, the outcome or size of the transaction or deal. According to the SEC, the presence of any of these factors indicates that a person may need to register as a broker.<sup>3</sup>

The SEC has traditionally indicated that individuals who “do nothing more than bring merger and acquisition-minded persons or entities together and who do not participate in negotiating the sale of securities, engage in any due diligence or share in any profits realized, are probably not brokers and would not be required to register as such.”<sup>4</sup> In contrast, the SEC has also said that a professional who brings together potential buyers and sellers and advises the parties on questions of value, plays an integral role in negotiating the transaction or provides other services designed to facilitate the transaction, is a broker.<sup>5</sup>

The SEC has also looked askance at the presence of transaction-based compensation in its inquiry into whether a person is a broker, stating that “the receipt of compensation related to securities transactions is a key factor that may require an entity to register as a broker-dealer. Absent an exemption, an entity that receives securities commissions or other transaction-based compensation in connection with securities-based activities that fall within the definition of “broker” or “dealer” generally is itself required to register as a broker-dealer.”<sup>6</sup>

The SEC appears to be moving closer to the conclusion that the mere presence of transaction-based compensation, where a finder engages in anything other than an introduction, indicates that a person is a broker. For instance, those No-Action Letters that do not require registration where transaction-based compensation is present can be distinguished from those that do by the fact that in the former

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## Maryland Governor Signs 3 Bills Addressing Mortgage Fraud, Foreclosure, and Foreclosure Rescue Transactions

*By Wingrove Lynton, Esq. and Catherine Brennan, Esq.  
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In the wake of the subprime mortgage crisis that has rocked the United States economy over the last year, Maryland Governor Martin O'Malley has signed three new measures recently enacted by the Maryland General Assembly that attempt to mitigate the harm caused by the fallout of the crisis.

**Mortgage Fraud Protection Act:** Senate Bill 217 and its companion bill, House Bill 360, ("Mortgage Fraud Protection Act") create the new crime of mortgage fraud, defined as an action made by a person with the intent to defraud that involves: (1) knowingly making any deliberate misstatement, misrepresentation, or omission during the mortgage lending process with the intent that any party to the "mortgage lending process" rely on the misstatement, misrepresentation, or omission; (2) knowingly using or facilitating the use of any deliberate misstatement, misrepresentation, or omission during the mortgage lending process with the intent that any party to the mortgage lending process rely on the misstatement, misrepresentation, or omission; (3) receiving any proceeds or any other funds in connection with a mortgage closing that the person knows resulted from a violation of (1) or (2) above; (4) conspiring to violate any of the provisions of (1), (2), or (3) above; or (5) filing or causing to be filed in the land records any document relating to a mortgage loan that the person knows to contain a deliberate misstatement, misrepresentation, or omission. The Mortgage Fraud Protection Act covers virtually all activities that occur during the "mortgage lending process," application through closing, and empowers the Maryland Attorney General and the Commissioner of Financial Regulation to enjoin a person from engaging in mortgage fraud. The Attorney General, along with each of the State's Attorneys in Maryland's 24 jurisdictions, can conduct criminal investigations and prosecutions of mortgage fraud cases. The Mortgage Fraud Protection Act establishes strict criminal penalties and permits individuals to file a private cause of action for damages caused as a result of mortgage fraud and to obtain damages equal to three times the amount of the actual damages.

**Foreclosure Process Reform Bill:** Senate Bill 216/House Bill 365 (the "Foreclosure Process Reform Bill") requires a mortgage, deed of trust, or any other instrument securing a mortgage loan on residential property to contain information about the mortgage originator and the mortgage lender. Mortgage originators and mortgage lenders exempt

from licensing must provide an affidavit indicating such exemption. The bill directs the Commissioner of Financial Regulation to adopt regulations to implement these new requirements. Section 4 of Senate Bill 216 provides that until the Commissioner adopts regulations under § 3-104.1(c) of the Real Property Article, the failure to include the information when recording a mortgage, deed of trust, or any other instrument securing a loan, "may not be the basis for a clerk of the court to fail to record the instrument." The Commissioner has not yet issued regulations, and until she does so, lenders may record security instruments that do not contain the new information.

The Foreclosure Process Reform Bill also establishes a time period before which a secured party cannot file an action to foreclose. Under the provisions of this bill, a secured party cannot file an action to foreclose a mortgage or deed of trust on residential property until the later of: (1) 90 days after a default in a condition on which the mortgage or deed of trust provides a sale to take place; or (2) 45 days after the secured party sends Notice of Intent to Foreclose. The secured party must send a copy of each Notice of Intent to Foreclose to the Commissioner of Financial Regulation whenever the secured party sends a mortgagor the Notice. The Notice of Intent to Foreclose must: "(i) be in the form that the Commissioner of Financial Regulation prescribes by Regulation; and (ii) contain: 1. The name and telephone number of: a. The secured party; b. The mortgagor servicer, if applicable; and c. An agent of the secured party who is authorized to modify the terms of the loan; 2. The name and license number of the Maryland mortgage lender and mortgage originator, if applicable; 3. The amount required to cure the default and reinstate the loan, including all past due payments, penalties, and fees; and 4. Any other information that the Commissioner of Financial Regulation requires by regulation." The legislation provides that until the Commissioner adopts regulations on the form of the Notice of Intent to Foreclose, secured parties may use their own form as long as it complies with the new legislation. The Commissioner has promulgated emergency regulations that include the required form of the Notice of Intent to Foreclose.

**Senate Bill 218/House Bill 361:** In May 2005, Maryland enacted the Protection of Homeowners in Foreclosure Act to protect consumers during the foreclosure process. Senate

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# Avoid Lock-Ins of LLC Minority Members

By Razvan E. Miutescu  
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An operating agreement of a Maryland limited liability company (an “LLC”) that does not require the unanimous consent of the members for its amendment leaves the minority member(s) vulnerable to oppression and investment lock-in – even if it provides for voluntary withdrawal or buy-out rights. When faced with a draft operating agreement of such nature, counsel for the minority member(s) should negotiate, at a minimum, if possible, for the inclusion of corporate-style rights of appraisal and/or judicial dissolution, preferably both. For the sake of simplicity, this text addresses these issues in the context of a two-member LLC.

Adopting corporate appraisal rights provisions is an effective way to avoid “lock-ins” – that is, the majority member acting to deprive the minority member of any independent right to exit the LLC. The LLC appraisal rights statute, Md. Corps. & Ass’ns § 4A-705, unlike its corporate counterpart, Md. Corps. & Ass’ns § 3-202(a)(4), does not confer appraisal rights (i.e. the right to demand and receive the member’s fair value of his or her interest) on a minority member in the event the operating agreement is amended such that it “substantially adversely” affects the minority member’s rights. Absent unanimous consent requirements, a majority member intent on engaging in oppressive behavior may single-handedly amend the operating agreement to deprive the minority member of any distributions, to restrict or deny employment, and to lock the minority member in his or her investment indefinitely. The LLC statutes permit the majority member to deny the minority member the practical alternative of withdrawing from the LLC by amending the operating agreement to that effect. *See* Md. Corps. & Ass’ns § 4A-605. The law also permits the majority member to do away with any express buy-out rights the minority member may have had in the operating agreement. In contrast, such unilateral actions on the part of a majority stockholder may trigger the minority stockholder’s appraisal rights. A minority stockholder who negotiated an express appraisal rights provision into the corporation’s charter is likely to be entitled to appraisal rights if the majority stockholder “al-

ters the contract rights, as expressly set forth in the charter, of any outstanding stock and substantially adversely affects the stockholder’s rights” by amending the charter to eliminate the minority stockholder’s express appraisal rights, unless, of course, the right to such alteration is reserved by the corporate charter. *See* Md. Corps. & Ass’ns §§ 3-202(a)(4) and (c)(4).

Adopting corporate judicial dissolution provisions offers an exit from an oppressive company environment. A court may dissolve a corporation on grounds that the acts of those controlling the corporation are “illegal, oppressive, or fraudulent.” Md. Corps. & Ass’ns §3-413(b) (2). Despite oppressive behavior by the majority LLC member, however, a court may dissolve an LLC only if the majority member’s acts are such that they make it not “reasonably practicable to carry on the business in conformity with the articles of organization or the operating agreement.” *See* Md. Corps. & Ass’ns § 4A-903. Since Maryland case law does not address the issue of whether oppression renders the operation of an LLC as not “reasonably practicable,” adopting the corporate oppressive conduct standard for dissolution brings clarity into the members’ relationship.

In negotiating the inclusion of appraisal rights and judicial dissolution provisions, counsel for the minority member can make the following points: (1) the provisions are necessary to avoid oppression and lock-in; (2) the provisions are preferable to including a unanimous consent requirement, the power of which can be abused by a minority member to hold the majority member “hostage”; and (3) it should be acknowledged that the inadequacy of statutory protections for minority members is largely attributable not to any business purpose but to estate tax planning under an estate tax regime that ignores, for purposes of discounting the value of minority interests, contractual restrictions on minority rights that are more restrictive than default state statutes. *See, e.g.,* I.R.C. § 2704(b) and *Knight v. C. I. R.*, 115 T.C. 506, 519 (U.S. Tax 2000).



# Changes to Federal Acquisition Regulations

By Meredith Blake Martin, Esq.  
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Recent changes to the Federal Acquisition Regulations ("FAR"), codified at Title 48 of the Code of Federal Regulations, impose new requirements on certain government contractors with respect to codes of business ethics and conduct. Specifically, on November 23, 2007, a Final Rule was published in the Federal Register, 72 Fed. Reg. 65873, and on December 24, 2007 two new FAR clauses became effective: 48 C.F.R. § 52.203-13 and 48 C.F.R. § 52.203-14. These provisions apply to government contractors who receive an award in excess of \$5 million with a period of performance of at least 120 days. The regulations require contractors who meet these criteria to prepare a Code of Business Ethics and Conduct ("Code"), and also to display certain information, including the OIG fraud hotline poster, at work locations and online.

There are also requirements for a training program, awareness and compliance programs, and internal controls in connection with the Code, although these additional requirements do not apply to small businesses. Nonetheless, it may be advisable for small businesses to implement ethics training and other internal controls to demonstrate good faith efforts towards compliance.

Under the new regulations, contractors have just 30 days from the award of any government contract in excess of \$5 million to implement a code of ethics and business conduct (this time period may be extended by the contracting officer and the requirement does not apply to contracts awarded prior to December 24, 2007). 48 C.F.R. § 52.203-13. A copy of the Code must be furnished to each employee involved in the performance of the contract, and the contractor is required to promote compliance with its Code. *Id.*

Training and compliance programs should be suitable to the size of the company and the extent of its involvement in government contracting; should facilitate timely discovery and disclosure of improper conduct in connection with government contracts; and should ensure corrective measures are promptly instituted and carried out. 48 C.F.R. § 3.1002.

Code provisions may include the following:

- General commitments to ethical conduct (i.e., obeying laws and regulations, including those related to anti-trust, insider trading, and procurement).
- Explanation of business practices (including with respect to bid, negotiation, and performance of govern-

ment contracts, as well as conflicts of interest, gifts/courtesies, and the like).

- Appropriate use of company resources (including time, property, intellectual property and information, government classified information, software and computers).
- Administration of the Code (including distribution, amendment, compliance, and identification of a Code Administrator).

In order to prepare a Code which is tailored to each client's business model and policies, also consider interviewing the client with respect to the following:

- Current company policies and practices relevant to any Code.
- Identification of key individuals to provide input and review drafts of Code.
- Identification of a compliance officer who will have ultimate responsibility for managing the Code, reporting regarding the Code, and maintaining employee awareness.

In addition to satisfying new requirements for certain government contractors, a code of ethics and business conduct is an excellent opportunity to consider and highlight a company's commitment to ethical business practices, as well as audit compliance with applicable laws and regulations which may impact the contractor's business.



## Don't Stray Too Far . . .

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situations, and consistent with the SEC's overall position on the matter, the finder's activities were generally limited to making an introduction of the parties to the ensuing securities transaction.<sup>7</sup>

Section 15(a) of the 1934 Act prohibits a broker from effecting transactions in, or inducing or attempting to induce, the purchase or sale of, any security other than exempted securities (as defined in § 3(a)(12) of the Securities Act of 1933 and including government and municipal securities and other similar securities) unless it is registered under § 15(b) of the 1934 Act.

Section 29(b) of the 1934 Act provides that failure to register as a broker voids any contract for the performance of services in violation of the provisions of the 1934 Act. This includes a violation of the broker registration requirements. The Supreme Court stated in *Mills v. Electric Auto-Lite Co.*<sup>8</sup> that § 29(b) implies a private right of action and that "[t]he interests of the victim are sufficiently protected by giving him the right to rescind..." Two other courts have reached the same result as it applies specifically to unregistered brokers even where the services under the illegal contract had already been performed.<sup>9</sup> Noting that the result may be harsh and even draconian, the *Regional Properties* court stated

Were this not the result there would be no civil remedy for failure to register. Because fees are usually contingent, as they were here, the broker who has not performed is entitled to no fee. If the broker who has performed can recover his commission despite non-registration, then the prohibition is a toothless tiger.<sup>10</sup>

Finally, in April 2008, the New York Supreme Court held that a contract between the defendant and a now-dissolved affiliate of the plaintiffs, pursuant to which the affiliate had been retained to provide financial advisory and investment banking services and act as sole agent for the private placement of the defendant's securities, was void *ab initio* and unenforceable by reason of § 29(b) of the 1934 Act. The court found that the finder had failed to register as a broker under § 15(a) of the 1934 Act.<sup>11</sup>

Keeping all of this in mind, when representing an individual or company claiming to provide only finding services, do not simply take his or its characterization at face value. You must determine what kind of services the finder is actually providing in connection with the transaction. Otherwise,

you may find yourself dealing with a void finder's fee agreement, and your client will not be entitled to remuneration under the agreement and will even have to return any payments already made by the contracting party. Further, an issuer who deals with an unregistered broker should challenge a finder straying from his or its intended purpose. Form D requires disclosure of the presence of a broker and the commission paid to such broker under a Regulation D exempt offering. Failure to disclose the use of a broker (albeit called a finder) will result in an incorrect Form D filing. The use of a broker may also affect the applicability of state law securities exemptions.

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### Footnotes:

<sup>1</sup> *Dominion Resources, Inc.*, SEC No-Action Letter, 2000 SEC No-Act. LEXIS 304 (March 7, 2000) (withdrawing *Dominion Resources*, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2511 (August 22, 1985)). See also, *Guide to Broker-Dealer Registration* (2005) (available at <http://www.sec.gov/divisions/marketreg/bdguide.htm>) (hereinafter "Broker Dealer Guide"); *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, ABA Section of Business Law, 60 Bus. Law. 959 (2005) (hereinafter "Broker-Dealer Report").

<sup>2</sup> John Polanin, Jr., *The "Finder's" Exception from Federal Broker-Dealer Registration*, 40 Cath. U. L. Rev. 787, 793 (1991).

<sup>3</sup> Broker-Dealer Guide at 3-4.

<sup>4</sup> *Paul Anka*, SEC No-Action Letter, 1991 SEC No-Act. LEXIS 925 (July 24, 1991); *Victoria Bancroft*, SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2517 (August 9, 1987); *International Business Exchange Corporation*, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 3065 (December 12, 1986).

<sup>5</sup> See *Wesco Equity Funding*, SEC No-Action Letter, 1985 SEC No-Act. 2634 (August 10, 1985); *Garrett Kushell Associates*, SEC No-Action Letter, 1980 SEC No-Act. LEXIS 3744 (September 7, 1980); *Castagana Business Brokerage*, SEC No-Action Letter, 1980 SEC No-Act. LEXIS 3298 (May 15, 1980); *Bay Business Service* SEC No-Action Letter, 1977 SEC No-Act. LEXIS 642 (Mar. 14, 1977); *Gary*

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## Proposal to the MSBA Board of Governors for the Creation of Section Governors

The sections of Business Law, Real Property, and Estates and Trusts (with the support of the section of Litigation) have recently submitted to the MSBA Board of Governors a proposal for the creation of certain "Section Governor" positions within the Board of Governors. The proposal calls for an increase in the number of members of the Board of Governors by five; from thirty-nine (39) to forty-four (44) total members. These proposed additional seats on the Board of Governors would be occupied by members of the five largest substantive law sections (i.e., sections with over 1,000 members). Each of the five substantive law sections would elect from its members a representative to sit on the Board of Governors for a period of two years.

Because of the increased specialization of lawyers, most

lawyers are active in the MSBA through their substantive law sections. The proposal would better align the way in which most members are active with the manner in which the MSBA governs itself. It is expected that this change would improve communication between the sections and the Board of Governors. The proposal would be implemented by a proposed amendment to the MSBA bylaws.

The proposal was sent to the Board of Governors, which has appointed a task force to review the proposal. A copy of the proposal can be obtained on request from Eric Orlinsky (eorlinsky@saul.com). We would encourage the members of the Business Law Section to contact members of the MSBA Board of Governors to express their support for the proposal.

### Mortgage Fraud...

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Bill 218/House Bill 361 expands this Act to prohibit "foreclosure rescue transactions," defined as a transaction: (1) in which a residence in default is conveyed by a homeowner who retains a legal or equitable interest in all or part of the property, including an interest under a lease-purchase agreement, an option to reacquire the property, or any other legal or equitable interest in the property conveyed; and (2) that is designed or intended by the parties to prevent or delay actual or anticipated foreclosure proceedings against the residence in default. The Act now applies to title insurers, title insurance producers and mortgage brokers, parties to the process previously exempted under the Act. The legislation also requires foreclosure consulting contracts to disclose the duty of the foreclosure consultant to provide the homeowner with written copies of any research the consultant has regarding the value of the homeowner's residence in default. The legislation further revises and expands the notice a foreclosure consultant must give the homeowner. Finally, the legislation requires some foreclosure consultants to obtain a real estate broker's license.

### Don't Stray Too Far . . .

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*L. Pleger, Esq.*, SEC No-Action Letter, 1977 SEC No-Act. 2491 (September 9, 1977); *Ruth Quigley*, SEC No-Action Letter, 1973 SEC No-Act. LEXIS 3177 (June 14, 1973); *May-Pac Management Co.*, SEC No-Action Letter, 1973 SEC No-Act. LEXIS 1117 (December 20, 1973). . See also *Hallmark Capital Corporation*, SEC No-Action Letter, 2007 SEC No-Act. 509 (June 11, 2007).

<sup>6</sup> *Herbruck, Alder & Co.*, SEC No-Action Letter, 2002 SEC No-Act. LEXIS 598 (June 4, 2002). See *Richard S. Appel*, SEC No-Action Letter, 1983 No Act. LEXIS 2035 (February 14, 1983); *Mike Bantuveris*, SEC No Action Letter, 1975 SEC No-Act. LEXIS 2158 (September 23, 1975); *May-Pac* No-Action Letter., *Supra*.

<sup>7</sup> *Paul Anka No-Action Letter, Supra; International Business Exchange Corporation No-Action Letter, Supra.*

<sup>8</sup> *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375,388 (1970).

<sup>9</sup> *Eastside Church of Christ v. Nat'l Plan, Inc.*, 391 F.2d 357, 362 (5th Cir. Tex. 1968); *Regional Properties, Inc. v. Financial and Real Estate Consulting Co.*, 678 F.2d 552, 561 (5th Cir. Tex. 1982).

<sup>10</sup> *Regional Properties*, 678 F.2d. at 564.

<sup>11</sup> *Torsiello Capital Partners LLC v. Sunshine State Holding Corp.*, No. 600397/06 (N.Y. Sup. Ct. 4/1/08).

# 2008-2009 Section Council Roster

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