MIKE HUCKABEE
GOVERNOR

MICHAEL B. JOHNSON
COMMISSIONER

HERITAGE WEST BUILDING, SUITE 300
201 EAST MARKHAM STREET
LITTLE ROCK, ARKANSAS 72201-1692
TELEPHONE: (501) 324-9260
FACSIMILE: (501) 324-9268

ARKANSAS SECURITIES DEPARTMENT

December 7, 2004

Mr. John E. Pruniski, III
Hilburn, Calhoon, Harper, Pruniski & Calhoun, LTD
P. O. Box 5551
North Little Rock, AR 72119

RE: HSV Dreamhomes, LLC
No Action No. 04-90000326-NA009

Dear Mr. Pruniski:

This Department is in receipt of your letter dated November 12, 2004, requesting the staff's position as regards the necessity of registration under the Arkansas Securities Act, Ark. Code Ann. § 23-42-101, *et seq.* (the "Act"), for the offer and sale of equity memberships in HSV Dreamhomes, LLC (the "Company"), a proposed Arkansas limited liability company which will own and operate a private vacation home located in Hot Springs Village, Arkansas. The facts, as more fully set out in your letter and the accompanying proposed Operating Agreement, are as follows:

Brent Gray and D.C. Reed have plans to form the Company, the purpose of which will be to own a vacation home in Hot Springs Village. The company will be limited to ten members, each holding a 10% interest in the Company, and each of whom will be entitled to use the vacation home for five weeks out of each calendar year. The Company will be member managed, all Company decisions being made by majority vote, and will make an election with the IRS to be treated as a partnership rather than an association for tax purposes. Your letter states that the Company is not structured as a profit-making venture, that the members will not be participating in the Company with an expectation of profits, and that the units of membership will not be marketed as an investment, but rather as an ownership interest entitling a member to five weeks of use of the facility. It is noted that the Operating Agreement for the Company does not in any way limit the potential for profit which might be received by a member upon sale of his interest, nor does it strictly limit the number of members to ten or fewer, although the number of units to be issued is limited to ten non-fractionalized units.

Your letter states that there will be a property manager to handle bookkeeping matters and be responsible for various ministerial duties. The Operating Agreement does list some duties of the property manager, although neither your letter nor the Operating Agreement delineates the exact extent of such bookkeeping matters and duties.

According to your letter, the initial property manager is to be RG Resorts, LLC, a proposed Arkansas limited liability company to be controlled by Gray and Reed. It is assumed

WRITER'S DIRECT DIAL: (501) 324-8686
EMAIL: john.moore@mail.state.ar.us
TOLL NUMBER: (800) 981-4429
WEBSITE: www.state.ar.us/arsec

that Gray and Reed will also be the primary owners of RG Resorts. It is contemplated that RG Resorts will also be a member of the Company, but, in consideration of its functions as property manager, RG Resorts will not be required to pay a share of the Company's annual operating expenses, as will other members. The Operating Agreement provides that the property manager can be changed by majority vote of the members.

Lastly, the Operating Agreement provides that any member can sell his unit, albeit with some restrictions. Section 6.1 states that no fractional or additional units (other than the original ten to be issued) are authorized, and provides that upon death of a member, his interest may pass to his heirs. It is my understanding from our telephone conversation of November 24, 2004, that it is planned that such heirs will own any such interest as tenants in common.

Although members of the Staff of the Department have on a number of occasions informally opined that interests in a member managed limited liability company ("LLC") that elects to receive tax treatment as a partnership have many characteristics in common with general partnership interests, and might for that reason be more akin to such interests than to securities under the Act, there has been little or no formal declaration of such a position. As noted in your letter, a no action position similar to that requested was rendered in 1994 regarding Pro Pick, LLC, but that opinion appears to have been based more on the necessity of each member's participation in the activities of the limited liability company in order to derive a profit than on the mere fact that the limited liability company was a member managed LLC.

The issue of whether interests in a limited liability company constitute securities under blue sky laws has been the subject of conflicting discussions. Although an interest in a member managed limited liability company has many of the same characteristics as an interest in a general partnership, the drafters of the 2002 Uniform Securities Act opted instead to include such an interest in the definition of a security. The 2002 Uniform Act provides in pertinent part as follows:

> "Security" means a note …*investment contract* ...or right to subscribe to or purchase, any of the foregoing.
> The term… includes as an "investment contract" an investment in a common enterprise with the expectation of profits to be derived primarily from the efforts of a person other than the investor and a "common enterprise" means an enterprise in which the fortunes of the investor are interwoven with those of either the person offering the investment, a third party, or other investors; and *includes as an "investment contract," among other contracts, an interest in a limited partnership and a limited liability company* and an investment in a viatical settlement or similar agreement.

It seems that the units to be issued would likely be considered securities under the definition in the 2002 Uniform Act. However, the 2002 Uniform Act has not been enacted in this state.

Under present Arkansas law, the issue of whether limited liability company interests constitute securities is determined based on an "investment contract" analysis, in which one looks at the characteristics of the interests under the traditional tests for such transactions. Under federal law and many state jurisdictions, whether a given transaction constitutes the sale of security is based upon the factors enumerated in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), in which the U.S, Supreme Court stated that:

> "...an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party..."

Later cases have somewhat softened the requirement that the profits be derived solely from the efforts of one other than the investor, but the essential characteristics as set forth in *Howey* still form the basis of most decisions in which the status of an investment contract must be determined for purposes of application of the securities laws.

In comparison, The Arkansas courts have generally followed a modified test proposed by Professor Joseph Long and first adopted in *Smith v. State*, 266 Ark. 861, 587 S.W.2d 50, holding that:

> "[T]here are five significant common characteristics of traditional securities. These common factors can be used to establish a uniform test for the identification of all securities, whether of a specific type or of a general nature, intended to be covered by the act in question, unless a specific contrary definition is contained therein. These elements are: (1) the investment of money or money's worth; (2) investment in a venture; (3) the expectation of some benefit to the investor as a result of the investment; (4) contribution towards the risk capital of the venture; and (5) the absence of direct control over the investment or policy decisions concerning the venture. Professor Long summarized by stating that a security is an investment of money or money's worth in the risk capital of a venture with the expectation of benefit to the investor where the investor has no direct control over the investment or policy decisions of the venture."

The facts as represented in your letter support the conclusion that the form of ownership of the vacation house, i.e., through a limited liability company, and the units to be issued are not intended to be as much for investment profit or benefit as for the limitation of liability to members and the use of the facility. Although there exists a potential for profit deriving from the possibility of appreciation of the real property occurring after a member buys his unit, that potential does not appear to be the primary motivation for purchase of a unit, and you have represented that the transaction is not structured or presented as a profit-making venture. Simply put, the attractiveness of the units to the potential members appears to involve use of the facility for five weeks out of each year, as opposed to the enticement for profit as a result of appreciation.

In addition, it appears that the potential members have some direct control over the policy decisions of the venture, although this aspect is somewhat blurred by the fact that the promoters of the venture, Gray and Reed, will control, at least initially, the limited liability company that is to manage the property. It is noted that the duties of the property manager delineated in the Operating Agreement of the Company are primarily ministerial in nature, and that matters which would normally constitute "policy decisions" appear to be reserved to the members. The staff is of the opinion that in most instances involving whether interests in a small, member-managed limited liability company in which the members have real control over the policy and business decisions of the issuer constitute securities, the interests will usually be deemed to fall outside of the definition of securities under the Act due to the fact that the "control" factor in both the *Howie* and the *Smith* test is not met. As is often the case in this type of analysis, the specific facts and provisions of the operating agreement will be controlling as to whether the members' control is actual or merely a pretext designed to thwart the registration provisions of the Act. Inasmuch as the Company's Operating Agreement places the primary policy and business decisions in the Company's members, the control factor of the tests does not appear to be met in this instance.

Based upon your representations as set forth above, and more particularly in your letter and the accompanying Operating Agreement, the staff of the Department will not recommend enforcement action to the Commissioner if interests in the Company are offered and sold as represented without a registration or exemption filing being made with the Department.

Please note that the position of the Department is based upon the representations that you have made in your letter referenced above. Different facts and circumstances might well result in a different position being taken. Additionally, the position expressed deals only with anticipated or possible enforcement action, and does not purport to be a legal opinion or to affect any civil liability that may exist.

Should you have any questions, please contact me.

Yours truly,

John E. Moore, Jr.
Chief Counsel