Stock Sales and Seller Financing – A Recipe for Rescission of M&A Transactions

Dan Maloney CPA CFP® CM&AA CBI

With the credit environment continuing to challenge small businesses and tax law change proposals continually in the headlines, stock structured transactions and use of seller financing continue to be tools of the trade when entrepreneurial businesses are sold. The use of a stock structure and/or seller notes can present severe and unintended consequences which may derail the otherwise desired transaction.

The Giant has Awakened

Once a dormant issue, the need for revision in securities licensure regulations is reaching a critical stage. For several years the community of securities attorneys and M&A advisors has been concerned about consequences that may result from an unlicensed broker's receipt of transaction based fees. Congress has now taken note. The concern stems from the threat of rescission of M&A transactions consummated in the past. The unintended rescission consequences stem from securities law violations since small business stock and seller notes fall within the definitional framework of a security. Under federal law, and the laws of several states, when a broker/advisor receives transaction based compensation in a securities transaction, the broker/advisor must have a securities license. Otherwise, securities laws may be violated which could result in a legal action for rescission of the transaction for a period of several years after completion of the transaction. Conceivably, this could give business buyers "a free look" and "deal insurance" within the time parameters of the statutes of limitations dealing with securities transactions.

Hooray for Florida

It should be noted that Florida amended its statutes in 2016 to exempt M&A Brokers from securities licensure for lower middle market transactions. However, the federal securities laws have not yet been changed.

The Morph Concern

Securities law violation concerns caused by financing with seller notes adds to the growing securities issues present when asset structured M&A transactions morph into stock structured deals. The licensure issue caught the eye of Congress and has now risen to the forefront in light of the introduction of legislation for the past several years. The U.S. House of Representatives has consistently passed bills that would exempt M&A Brokers from securities licensure. The issue lies with the Senate, which has not followed the lead of the House. If the U.S. Senate can write and pass a similar Bill, and if the negotiated final version passes the joint Congressional vote, the legislation would put an end to the fear of deal rescission if unlicensed M&A Brokers handle the transaction.

Background and analysis: The Grim Reaper Cometh

Before 1985, brokers and transaction advisors operated under what was termed

"*the sale of a business doctrine*." Under this doctrine, if the sale of all of the stock of a business (as contrasted to a transfer of the business via the sale of its assets) was the means of transferring a business from one person to another, with the intent that the buyer was going to operate it, the deal was not "considered" to be a sale of stock, and therefore not subject to securities laws. It was considered an entrepreneurial transaction rather than an investment in stock. Courts favoring the sale of a business doctrine rejected a literal reading of the securities laws and instead, looked at the economic realities of the transaction. Under federal securities laws, this view was rejected in 1985.

All Stocks are Created Equal

In 1985, the U.S. Supreme Court negated the sale of a business doctrine in the Landreth Timber decision, 471 U.S. 681. In the Landreth case, the petitioners sued for rescission due to a violation of the registration provisions of the Securities Act of 1933 and the antifraud provisions of the Securities Exchange Act of 1934. The Supreme Court, in overruling the District Court and Court of Appeals, essentially ruled that a stock is a stock is a stock. It took a literal reading of the law and held that if the instrument is called "stock" and has the characteristics traditionally associated with stock, then a purchaser may assume that federal securities laws apply.

OOPs

The Court may not have meant to place the sale of a small business under the jurisdiction of the SEC, but that's what transpired. Since the Court's decision, small business stock and securities transactions have fallen under the same regulations as the retail sale of 100 shares of stock of a multinational company.

The Long and Winding Road Begins

Subsequent to the Court's ruling in 1985, the International Business Exchange Corp. (IBEC), a Texas based business brokerage firm, sought guidance on how to deal with the sale of a small business in a transaction initially structured as an asset sale but, due to negotiations between buyer and seller, could be transformed into a stock sale. It requested and received a "no action letter" from the SEC based on the facts presented. In the no action letter, the SEC indicated that it would not pursue prosecution for unlicensed violation of securities laws if very limited and specific requirements were followed when a small business was sold in a securities transaction by brokers. The business brokerage industry operated under the requirements of the no action letter for over 20 years.

In 2005, after a "quiet period" *of twenty years*, the American Bar Association's task force on Private Placement Broker-Dealers issued a report discussing regulatory problems with unlicensed advisors who facilitate capital raising. *"Nevertheless, those advisors are, by the nature of their respective activities, unlicensed securities brokers operating in violation of the federal and applicable state securities laws." "Notwithstanding the various labels, and despite the fact*

that a great number of the brokers, funded businesses, and even sometimes their attorneys, do not realize that they are operating in violation of securities laws, simply put, they are unlicensed securities brokers whose fee contracts are unenforceable and whose activities are, in fact, illegal." (See www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf. Also see The Business Lawyer, May 2005.)

Certain members of the task force subsequently wrote to the SEC suggesting a new less stringent licensing requirement for Private Placement Broker-Dealers since "it is well known that hundreds of persons, probably thousands, regularly engage in …merger and acquisition activities that …require a securities broker's license." The letter discusses how smaller companies can enter *"into the unstable marshland of potential rescission rights… for the illegal activity of the unlicensed person, whose only "securities related activities" are those that are technically present as a result of the transaction being structured as a sale of stock instead of a sale of assets."*

The State of California, in 2005, amended its statues to provide rescission rights to a buyer who purchases securities from or through an unregistered broker-dealer or unlicensed intermediary. The statute also allows for monetary damages even if the purchaser no longer owns the securities.

In 2006, Country Business Inc., a business brokerage firm which was not securities licensed, was engaged in litigation resulting from an asset sale transaction which was changed into a sale of the stock of a small business. Following the litigation in this case, another no action letter was issued by the SEC, similar to that in the IBEC case.

In the record of proceedings of the SEC's 27th Annual SEC Government – Business Forum on Small Business Capital Formation Program (2008), a staff attorney stated, when discussing unlicensed activity of advisors, "…And that is because from the definitional point of view of a broker-dealer…we look at you as affecting transactions [in] securities. …*We have concerns about sales abuses that could happen and that's why we want you under the umbrella of broker-dealer regulation. And …if you're getting a transaction based fee, we consider you engaged in the business…"* Addressing federal registration of M&A brokers has been a priority issue of the Government–Business Forum on Small Business Capital Formation since 2006. See http://sec.gov/info/smallbus/sbforum.shtml.

In May 2009, the state of Utah sent letters to all business brokers in the state cautioning them about violation of securities laws. After reviewing the activities and promotional materials of brokers which often mention fund raising, investment banking and mergers and acquisitions, the Utah Dept. of Commerce concluded that *"A majority of the activities recently brought to the attention of Division staff would require licensure as a broker-dealer. …These activities would be difficult, if not impossible to conduct without being deemed a broker-dealer*

under the securities laws."

In 2010, a business broker in Nevada was engaged in a civil lawsuit seeking rescission of a 2006 transaction that was changed from an asset sale to a securities transaction. Both buyer and seller sides of the deal authorized the broker to proceed with the transaction with full knowledge of the lack of a securities license. Regardless of their agreement, it became clear that parties cannot cause an illegal action to become legal simply by agreeing to overlook the licensing requirements of the securities laws. The transaction closed in 2006, but the litigation claim for rescission was initiated in 2009, well after the business suffered severe setbacks.

In May of 2013, the Ohio Division of Securities issued a caution that acting as an unlicensed, compensated finder "is most often illegal and can result in any number of criminal, civil and administrative sanctions for violators." See Ohio Securities Bulletin 2013:2.

Smart Folks to the Rescue

Recognizing the growing seriousness of the securities licensure issue, the Alliance of Merger & Acquisition Advisors has actively pursued exemptions from FINRA's strict Broker-Dealer "one size fits all" licensing requirements that can affect business brokers and M&A Advisors. The AM&AA proposed a Merger & Acquisition Broker designation which would help protect advisors, buyers and sellers of businesses when the ownership of a small business is transferred in a stock or securities based transaction. The AM&AA's "Campaign for Clarity" Is making strong headway, but Congress is slow to act. The House of Representatives proposed and passed Bills that would exempt M&A Brokers from licensure in 2014, 2015, 2016 and 2017, but the Senate is yet to pass its own bill. Without the Senate's help, the licensure requirement will remain the law of the land.

The good news is that several state are actively addressing the licensure issue, including California, Ohio, Colorado, South Dakota, Utah, Texas, Florida, Vermont and Pennsylvania. Some of these state, including Florida, have amended their statutes to exempt M&A Brokers from Securities licensure.

A Shout Out to Florida

The Business Brokers of Florida sponsored an effort to have the Florida statutes amended to exempt brokers from securities licensure. As of mid-2016, no longer will a Florida deal be at risk of rescission if a non-securities licensed broker transacts a securities transaction and received transaction based compensation. What remains cloudy is the definition of a Florida transaction, since U.S Mail and internet advertising may be a factor. A change in federal securities law is needed to clarify the issue.

The SEC is the Boss

In 2014, the SEC issued a sweeping No Action Letter indicating it won't seek prosecution against M&A Brokers for certain stock based transactions. However, a No

Action Letter is only an opinion. It doesn't override federal law.

It is clear that the SEC regulations require registration of business brokers working for buyers and sellers of businesses in mergers and acquisition when securities are involved. Interested parties can view the SEC's broker-dealer guide at http://www.sec.gov/divisions/marketreg/bdguide.htm. Simply said, the main- street business broker or lower middle market M&A Advisor selling Dan's Donut Shop in a securities transaction needs the same licenses as a Wall Street investment banker selling shares of a multi-national public company.

When violated, Federal and State securities laws can render contracts void or unenforceable, can create civil remedies including rescission and can create opportunities for action against the broker and seller.

The Definition of a Security is Fairly Broad

Definitions are fairly broad. According to securities laws, a security can be any note, stock, debenture, certificate of interest or participation in any profit sharing arrangement. Also, the Securities Exchange Act of 1934 defines brokers as "Any person [or entity] engaged in the business of effecting transactions in securities for the account of others." (Transaction based compensation is a big factor.) Note: a seller note falls within the definitional framework of a security and that many SBA lenders require seller notes as a component of deal financing. Courts have held that a note is presumed to be a security unless it bears strong resemblance to instruments held not to be securities. State securities regulators also presume that a note is a security.

The United States Congress is taking note of the concerns faced by entrepreneurs wishing to exit their business. With the baby boomer generation reaching retirement age, there is an estimated 10 trillion dollars of business value to soon be transferred as the boomers exit the work force. That's more than enough to catch the eye of our legislators.

In today's lending environment, with lenders often requiring seller notes to be part of the financing package, there are red flags to look for. A seller note might be a security if the note is for more than 90 days, if the note is transferable, negotiable or assignable, if there are equity kickers, if the note is not secured or under secured, if the note is convertible and several other reasons. The issue is complicated, and the advice of a securities attorney should be sought when seller notes are involved, especially if the intermediary is not securities licensed.

The Inconvenient Truth

The issues discussed in this article include some "inconvenient truths." The inconvenient truth is that brokers engaged in securities transactions must be securities licensed, a sale of a business is always a securities transaction if it is a stock sale vs. an asset sale, a sale is always a securities transaction if it involves the sale of stock to an ESOP, a sale is always a securities transaction if it involves the issuance or exchange of stock for assets, and a sale may be a securities transaction if it involves a seller note.

When brokers and advisors facilitate a business sale that involves securities, they operate in violation of securities laws more often than they realize.

The ownership interest of a privately held company is considered a stock and a security even though it is not publicly traded. Accordingly, transaction advisors and consultants working with owners on the sale of businesses that are not fully structured as asset sales are most likely working within the regulatory area of securities law. The majority of transaction advisors are not securities licensed. The inconvenient truth is that these unlicensed advisors are putting the transaction at risk of rescission, even though they may have their client's best interest in mind.

Sellers Beware

When planning the sale of their businesses, entrepreneurs should take extreme caution if the transaction involves a security, especially when transaction based compensation is paid to an intermediary not licensed in securities. Professionals who have become actively involved in M&A related activities run the risk of crossing into the SEC's definitional framework of an unlicensed broker-dealer. This risk should not be unintentionally transferred to the entrepreneurs they serve. In today's risky economy, especially in light of the recently re-introduced legislation, business sellers should seek advice from an attorney practicing in the area of securities law to avoid the risk of rescission. The threat of rescission can be likened to a "buyer's insurance policy" which tips the scale too far toward the buyer's side of the negotiation table.

Entrepreneurs, when either investigating the sale of their business or beginning the exit planning process, should stay abreast of the changing landscape. They should take care to avoid unintentional and unnecessary exposure to the risks of the possible rescission of one of their most important business transactions. If they are planning to sell their business in an asset sale transaction, they should have a "Plan B" to protect themselves in the event that the transaction evolves into a securities related deal. They should be extra cautious when stock sales and seller financing are involved and seek the advice of a securities attorney.

About the author: Dan Maloney is a Certified Merger & Acquisition Advisor and Certified Business Intermediary. He is a Managing Director with Aria Capital Advisors, LLC, a broker-dealer and boutique investment banking firm where he holds Series 24, 79, 99, 62 and 63 securities licenses. He is also the Managing Member of Certified Acquisition Advisors LLC, a business brokerage and business exit planning consulting firm.