

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

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With the credit crisis continuing and tax laws 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.

Once a dormant issue, due in part to the struggling economy, securities licensure concerns have recently grown legs. Much concern has surfaced within the community of M&A Advisors due to consequences that may result from an unlicensed broker or other advisor's receipt of transaction based fees. The concern stems from the threat of a post closing rescission cause of legal action. The unintended rescission consequences stem from securities laws violations since small business stock and seller notes fall within the definitional framework of a security. 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 transaction rescission claim for a period of several years following 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.

The securities licensure concern is currently a priority issue being discussed by members of the Alliance of Merger & Acquisition Advisors. 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 recently rose to the forefront of discussion in light of a 2009 lawsuit filed against a prominent business broker in Nevada.

Background and analysis:

- 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, it 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. Under federal securities laws, this view was rejected in 1985.
- Before 1985, 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. However, 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 overruled the District Court and Court of Appeals and essentially ruled that 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 common stock, then a purchaser may assume that federal securities laws apply. 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.

- 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, the American Bar Association’s task force on Private Placement Broker-Dealers issued a report discussing, in part, regulatory problems with unlicensed advisors who facilitate capital raising. (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.”
- In 2006, Country Business Inc., a business broker 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.
- Recognizing the growing seriousness of the securities licensure issue, the Alliance of Merger & Acquisition Advisors has been actively pursuing exemptions from FINRA’s strict Broker-Dealer licensing requirements that can affect business

brokers and M&A Advisors. The AM&AA proposes 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 transaction. The AM&AA also proposes a new Private Placement Broker designation to legally facilitate capital raising for smaller companies.

- To facilitate licensed M&A activity and eliminate the onerous requirement that M&A Intermediaries who are compensated on a success fee basis be Series 7 licensed, FINRA recently added a new Series 79 licensing category, Investment Banking, to the list of licensing categories. The Series 79 material focuses on investment banking related topics such as mergers and acquisitions, capital raising, corporate financial analysis, fair value opinions, due diligence, and securities offerings. Series 79 candidates are not required to prove their competence in executing retail trades of securities. It is unclear at this juncture whether M&A Advisors structuring and selling M&A transactions need both a Series 7 (or equivalent) as well as a Series 79 license.
- The SEC requires registration of business brokers finding buyers and sellers of businesses in mergers and acquisition when securities are involved. (See the broker-dealer guide at <http://www.sec.gov/divisions/marketreg/bdguide.htm>).
- In the record of proceedings of the SEC's 27th Annual SEC Government – Business Forum on Small Business Capital Formation Program, 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..."
- 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."
- The State of California, in 2005, amended its statutes 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.
- Like most states, Florida law allows for rescission when sales are made in violation of securities laws. In Chapter 517 of the Florida Statutes, at 517.211,

“Every sale made in violation of either s. 517.07 or s. 517.12... may be rescinded at the election of the purchaser...”

- A business broker in Nevada is presently engaged in a civil lawsuit seeking rescission of a 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.

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.

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.) Notice that 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.

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 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.

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 properly 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, 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.

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