ROBERT G. HUTCHINS - LEGAL ESSAYS

Broker Registration Issues in Stock Acquisitions

Preliminary Note

Business and real estate brokers, investment bankers, accountants, lawyers and all manner of "finders" or "consultants" routinely participate in middle market M&A transactions that close as stock sales. Most of these participants do not realize that if they act as financial intermediaries in such transactions, but are not registered as securities brokers, the ice under them is very thin.

Consider a commonplace occurrence: The stockholders of a private corporation resolve to put the corporation in play. They assume any transaction will take the form of an asset sale, but with their tax position in mind they authorize an alternative stock sale if one can be arranged. In accordance with the resolution, the directors engage a business brokerage firm to find a buyer. The broker is highly regarded and knowledgeable about the corporation's industry. Its fee agreement provides for market-based compensation equal to a percentage of the final price. The compensation is contingent on closing and the broker must pay its own expenses.

Following a full due diligence investigation, the broker prepares a confidential disclosure memorandum for delivery to prospective buyers. The memorandum describes the corporation's business and operating history, summarizes its financial position, identifies its strengths without concealing its weaknesses and outlines the basic terms proposed for the deal. It mentions, but does not stress, the possibility of a stock sale. Because of the care with which it is written, the memorandum presents the corporation in the most favorable light consistent with the facts, but is not misleading. Indeed, it is extraordinarily well done, a testament to the skill and experience of the broker.

With a complete picture of the corporation at hand, the broker begins to identify likely buyers. It takes pains to do this accurately because a great deal of time can be wasted soliciting unsuitable prospects. The broker researches its internal files, consults business publications and trade journals and utilizes its extensive industry contacts. The broker then crisscrosses the country soliciting the most promising buyers and it participates in lengthy negotiations with the final bidders. All the while, the broker is in touch with the corporation's directors and executives answering their questions and helping them deal with bidders' representatives. The entire process consumes months, involves intense effort and carries considerable financial risk for the broker, but in the end a qualified buyer is found willing to pay an acceptable price, subject only to the execution of a satisfactory "definitive agreement." The initial assumption that the transaction will close as an asset sale has so far remained intact.

The negotiations for the definitive agreement proceed smoothly, due in large part to the broker's efforts. At the 11th hour though, as the result solely of technical factors, the transaction is consummated as a stock sale after all to the delight, and surprise, of the stockholders.

This happy ending, however, is illusory. It has not occurred to the broker that it has "effected a transaction in…or induced the sale of a security" within the meaning of the broker-dealer registration provisions of the Securities Exchange Act, but that is in fact the case. Because the broker is not so registered, its conduct from the beginning has been illegal. Its fee agreement is unenforceable and its failure to register, to say nothing of its general solicitation of buyers, has so tainted the stock sale that the exemption from registration on which the parties relied may be unavailable.

This Essay traces the evolution and summarizes the legal underpinnings of the broker registration requirement as it applies to stock acquisitions. It then suggests ways in which M&A participants can mitigate the risk of non-compliance.

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The Risk to M&A Advisers

The above illustration could easily have involved an accounting firm, a law firm, a real estate brokerage firm or another transaction participant whose advice or effort was integral to the closing. These participants are at risk because the definition of a securities broker subject to registration is so broadly written under current law that it covers persons who act as intermediaries in acquisitions as well as those who confine their activities to portfolio securities. [1]

Moreover, any distinction in the acquisition context between advisory services and mediation or brokerage activities can be murky, to say the least. Advice that a potential buyer is financially strong and otherwise appropriate for a transaction can be seen as the active solicitation of that buyer. Advice that optimum tax treatment requires a stock sale, as opposed to an asset sale, can effectively "induce the purchase or sale of securities." The SEC has stated categorically that, although acquisition services are an inherent part of their practices, accounting and law firms are required to register if, from a functional point of view, they are acting like brokers. They can do that by "assisting an issuer to structure prospective securities transactions, by helping an issuer to identify potential purchasers of securities, or by soliciting securities transactions…" and they may be "engaged in the business" of doing it if they receive "transaction-related" compensation or hold themselves out as intermediaries or finders. [2]

If the failure to register goes unnoticed, which often the case, the adviser/intermediary is compensated in accordance with its fee agreement and proceeds blithely to the next transaction, unaware of the mine field it has just crossed. But if the failure is discovered, the client may elect to rescind the fee agreement and recover any compensation actually paid even if the amount is reasonable and otherwise well deserved.[3]

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[1] The Exchange Act covers any broker engaged in interstate commerce, to wit; any broker. Section 3(a) defines "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." Section 15(a) makes it unlawful for a "broker" to "effect any transactions in, or to induce or attempt to induce the purchase or sale of any securities unless registered…" Section 29(b) provides that "Every contract made in violation of any provision of this title…shall be void." The states have equally broad provisions, e.g. California, (Corp. Code 25000-25023); Oregon (ORS 59.165) and Washington (RCW 21.20.005 (5). State registration is accomplished by filing copies of the Exchange Act documents and paying a fee. See, e.g. the Washington Administrative Code, WAC 460-20B-030.

[2] See e.g., with respect to accountants, "Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release No. 33-8183, Note 82, (February 5, 2003).

[3] For example, the fee agreement of an unregistered "consultant" that brokered the sale of limited partnership interests in a shopping center was held void in *Regional Properties, Inc. v. Financial and Real*

The Origin of the Problem

Prior to 1985, the Exchange Act's broker registration requirement did not alarm M&A professionals. The courts treated the sale of a controlling interest in the stock of a corporation to a single buyer as the functional equivalent of an asset sale for securities law purposes. The fact that the transaction was structured as a stock sale to achieve tax objectives, facilitate the transfer of contracts or otherwise continue the business as a going concern was irrelevant. The underlying rationale, called the "sale of company doctrine," was that a buyer purchasing control of a corporation could protect itself by obtaining access to inside information and imposing on the seller binding warranties respecting material facts. Such a buyer did not need the protection of the securities laws. An intermediary facilitating a stock acquisition by that buyer might have to register as a "business opportunity" broker, but not as a securities broker.[4]

Then, in a landmark 1985 case, the Supreme Court ruled that if an instrument bears the label "stock" and confers the legal rights and investment attributes associated with common stock (the right to vote, the right to receive dividends, the capacity to appreciate in value, etc.), it is so clearly a "security" that further debate about its nature is foreclosed. It does not matter whether the buyer assumes control of the issuer or whether the transaction is equivalent to an asset sale for most purposes. When common stock is sold (as opposed, say, to notes or various hybrid securities) the "sale of company doctrine" does not apply and the buyer may rely on the securities laws. From that day to this, persons engaged in facilitating stock acquisitions have been confronted by the registration provisions applicable to securities brokers.[5]

The ABA Report

In May 2005, a "Task Force" of the Business Law Section of the American Bar Association recommended the adoption of a scaled-down registration system for a new class of financial intermediary called a "Private Placement Broker-Dealer." The proposed definition of that term would cover intermediaries in business acquisitions structured as stock sales. In explaining its proposal, the Task Force cited a "major disconnect" between the broker registration requirements of the Exchange Act and the process by which private capital is actually raised and mid-market stock acquisitions are actually closed.[6]

The Task Force noted that broker-dealer registration under the Exchange Act involves a comprehensive examination procedure and requires such things as membership in the NASD and compliance with the net capital rule. Those requirements are not needed to license business brokers functioning solely as match-makers. Accordingly, the Task Force proposed the adoption of new regulations under which such brokers would be exempted from full registration. Though some level of registration would remain, the applicable examination and reporting requirements would be shortened and simplified. Pure match-makers could not participate in securities offerings to raise funds for a transaction, or in negotiations, nor could they advise on the value of securities, but they presumably would be authorized to promote the target as a going concern and to accept transaction-based compensation, even in a stock acquisition.

There appears to be a groundswell of support developing for the Task Force recommendations. For example, on December 7, 2005, the Capital Formation Subcommittee of the SEC's Advisory Committee on Smaller Public Companies advocated a "multi-agency" effort to create a streamlined NASD registration process based on the Task Force proposal. On September 13, 2006, the California Corporations Commissioner invited comments by the end of that year on a limited registration system for finders and private placement brokers operating in that state.

Estate Consulting Co., 678 F.2d. 552 (5th Cir. 1982). In further proceedings, the consultant's equitable claims for compensation were also denied because of its illegal conduct, 752 F.2d. 178 (5th Cir. 1985).

[4] The securities at issue in the *Regional Properties* litigation (note 2) were limited partnership interests whose owners, by definition, could *not* exercise control. The sale of company doctrine did not apply.

[5] See, *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985).

[6] See, *Report and Recommendations of the Task Force on Private Placement Broker-Dealers,* The Business Lawyer, Vol. 60 No. 3 (May 2005).

The SEC No-Action Letters

Pending the formal adoption of new regulations, however, we must assume that, as determined by the Supreme Court in *Landreth*, an acquirer purchasing common stock is *always* entitled to the full protection of the securities laws. It follows that any person who, as part of an ongoing business, solicits that acquirer or otherwise induces it to purchase the stock must be registered under the Exchange Act.

There have been instances, some involving stock acquisitions, others private placements, in which unregistered intermediaries have obtained "no-action" assurance from the SEC staff that, if the intermediary acted in accordance with specific representations, the staff would not recommend enforcement action against it. In some letters, the assurance was based on the fact that the transaction was an isolated occurrence, clearly not part of a regular business. In others, the intermediary promoted and negotiated only asset acquisitions and did not receive transaction-based compensation, the hallmark of a broker-dealer.[7]

By contrast, no-action assurance was denied out of hand and without comment when a registered broker-dealer that acted as a placement agent in private offerings proposed to pay transaction-based referral fees to an unregistered mortgage banker that would limit its role to the introduction of the parties. Presumably, the staff viewed the mortgage banker as simply an unregistered sales agent of the broker and the referral fee proposal as a fruitful source of abuse.[8]

Most of the favorable letters are conditioned on the absence of incentive compensation and they curtail substantially the very services M&A professionals are engaged to perform. On the other hand, the letters are not models of clarity or consistency and the staff has, on occasion, provided some tenuous comfort.[9]

The CBI Letter

In one of the most recent and encouraging letters granting no-action relief, the staff reacted sympathetically to the following operational method proposed by Country Business, Inc., ("CBI") a self-described and unregistered "business broker for small businesses."[10]

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[7] See, e.g., *Paul Anka,* SEC No-Action Letter (July 24, 1991), in which a singer introduced promoters of privately offered hockey team securities to well-heeled friends in the entertainment industry, but did not participate in negotiations and was compensated by a flat fee. His involvement was treated as an isolated occurrence. In *CommandTRADE, LP,* SEC No-Action Letter (December 28, 2005), an unregistered developer of a computerized investment analysis platform sold the platform to registered broker-dealers, but did not (a) charge transaction-based fees, (b) hold funds, (c) become involved in execution, settlement or clearance activities, (d) solicit or open brokerage accounts, (e) answer questions, provide advice or engage in negotiations between customers or brokers respecting transactions or strategies; (f) recommend particular securities or brokers or (g) screen customers for brokers.

[8] See *John W. Loofbourrow Associates, Inc.* SEC No-Action Letter (March 7, 2006). In *MuniAuction, Inc.*, SEC No-Action Letter (March 13, 2000) no-action assurance was denied the host of a website auction established for issuers and registered brokers. The host solicited the issuers and selling security holders through extensive advertising, transmitted orders and selected the broker-dealer that executed transactions.

[9] Compare *CommandTRADE, LP,* cited in Note 7, with *International Business Exchange Corporation*, SEC No-Action Letter (December 12, 1986), in which an unregistered business broker participated in stock acquisitions as part of its regular business and did so in exchange for a commission based on the final price. Nevertheless, the staff granted no-action assurance on representations by the broker that its commission was not dependent on structure, that it promoted only assets and made no structural recommendations and that it neither participated in negotiations nor provided valuation advice if the transaction closed as a stock sale. Neither the staff nor the broker explained how early advice about asset values, selling strategies and appropriate buyers, which the broker clearly provided, would suddenly become irrelevant when the parties determined to sell stock. The fact that the commission did not vary with the form of the transaction might seem to distinguish the engagement from stock brokerage, but only superficially.

√ *CBI would limit its clients to businesses that did not exceed the "Size Standards" for entities eligible to receive SBA grants or loans, or equity funding by Small Business Investment Companies.* The significance of the size limitation in the context of broker-dealer registration is not clear from either CBI's request letter or the staff's response, but the limitation was one of the factors the staff emphasized in granting no-action assurance. Presumably, the staff was sensitive to the fact that small businesses are not likely to receive the attention of registered broker-dealers.

√ *CBI would represent only selling companies and their controlling stockholders.* By confining its representation to one side of the transaction, CBI could eliminate the potential for conflicts of interest inherent in representing both buyers and sellers.

√ *Although CBI would promote transactions over the internet and by other mass media, only assets would be listed or offered for sale and the target would be offered as a going concern, not a "shell corporation."* This helps avoid any implication that the parties set out to sell stock and it eliminates the taint associated with promoters of dormant corporations with a registered class of securities but no current assets or business. Such "shells" are offered as merger candidates for private companies wishing to "go public" on the cheap. Shell corporations are worthless for that or any other purpose.

√ *If the transaction is consummated as a stock acquisition, all equity securities would be sold to a single purchaser or group of purchasers formed without CBI's assistance.* This factor helps distance CBI from any decision to sell stock. It also distinguishes a stock acquisition involving a change of control from a stock distribution masquerading as an acquisition.

√ *CBI would not advise any party whether to issue securities nor would it opine on the value of any securities actually sold, although it would be prepared to value the assets of the business on a going concern basis.* This is not a distinction without a difference. Of course the aggregate value of all outstanding equity securities of a close corporation and the aggregate value of all its net assets and business are the same, so at first blush it would not seem to matter how the opinion is characterized. But a corporation may issue multiple classes of securities that vary widely in their rights, preferences and limitations and therefore in their value to the holder. In any case, it is usually possible to acquire operating control of a corporation without purchasing all of its outstanding stock.

√ *If the parties determined to consummate the transaction as a sale of securities, CBI would not participate in negotiations other than to transmit documents, value the assets, provide administrative support and assist with preparation of financial statements. CBI expressly would not offer advice respecting the terms of the transaction.* An adviser recommends terms to one of the parties. A broker plays a major role in inducing the acceptance of common terms by all parties. The point at which recommendations become inducements can be difficult, if not impossible, to identify. The CBI letter finessed the issue and the staff did not object.

√ *CBI would prepare a disclosure memorandum based on information provided by the seller, but would disclaim any representation respecting the accuracy of such information. The memorandum would not discuss a possible sale of securities.* Most prudent intermediaries will make this disclaimer, but by stressing it, CBI distinguished itself from securities brokers who make representations and offer opinions on a variety of subjects including whether a given investment is suitable for their clients.

√ *CBI would be paid a fixed fee, an hourly fee, or a commission based on a percentage of the price actually received, but the fee would be negotiated in advance of any decisions about structure. The fee would be payable in cash or on a deferred basis corresponding to any deferral of the price and would not vary with the form of the transaction.* The staff's formal endorsement of a percentage commission paid under the circumstances described by CBI reinforces the position taken in the earlier *International Business Exchange Corporation* letter.[11]

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[10] See, *Country Business, Inc.*, SEC No-Action Letter (November 8, 2006).

[11] See Note 9 above.

√ *CBI would not help purchasers obtain financing other than to assist with paperwork and provide uncompensated introductions to possible lenders.* In a stock acquisition, assisting the buyer with financing is equated with inducing the purchase of the target's securities, to say nothing of the fact that all loans are evidenced by notes, which are themselves securities. This disclaimer also helps eliminate the potential for profiting from both sides of the transaction, a fact of life with broker-dealers.

Interim Recommendations

As of this writing (February 2007), nothing has been done to implement the Task Force recommendations for simplified registration. Here are some interim recommendations for M&A professionals who risk being treated as intermediaries but are not registered as securities brokers:

Follow the CBI Letter

SEC no-action letters merely reflect the current views of the staff. They are not binding on either the Commission or the courts. Moreover, any favorable assurance they provide is limited strictly to the facts represented by the applicant. It would be foolhardy to assume that plausible compliance with someone else's letter will always immunize an unregistered broker or adviser from exposure. Nevertheless, the letters are not written lightly and are given substantial weight. They should be followed whenever possible. The CBI letter is described in detail here because it is a particularly helpful example.

Register as a Business Opportunity Broker

M&A intermediaries, i.e., persons who bring buyers and sellers together as part of a business, should register under applicable state law as a "business" or "business opportunity" broker. Virtually all states include such laws as part of a comprehensive regime that also requires registration by securities, life insurance and franchise brokers, among others. The procedure is relatively simple and inexpensive. While not an assured defense to an enforcement action or civil claim, a business brokerage license adds a valuable aura of legitimacy and good faith.

Promote the Target, not the Stock

Unregistered M&A intermediaries should confine their activities to describing and promoting the assets and business of the target company as a going concern. If the target's form of organization is not apparent from its name, the promotional materials can certainly identify it as a corporation, limited liability company etc as the case may be, but any description of the number, distribution, rights and limitations of the target's securities should be prepared by the target's counsel, accountants and executives. The resulting division of labor should be established at an organizational meeting conducted at the outset of the transaction. As soon as it becomes apparent that the transaction will close as a stock sale, the intermediary should terminate all discussions with buyers or, at the least, confine the discussion to products, markets, etc. The latter course should be thoroughly documented.

Address Registration Issues in the Engagement Contract

Given the risks that face them, unregistered M&A professionals should cover registration issues frankly and comprehensively in their brochures, engagement letters and fee agreements. The securities laws are, from beginning to end, disclosure statutes. Full disclosure of the terms of engagement of a business broker or acquisition advisor will be an indispensable component of their securities law compliance programs. The brochures of most professionals contain a laundry list of their degrees, honors and memberships along with a glittering summary of past deals and triumphs. It is not difficult to add a statement to the effect that the professional is not a registered securities broker, is not in the business of effecting securities transactions and is not being engaged to do so. That statement can provide the basis for contract provisions of the type approved by the CBI no-action letter.

Disclaim Structural Recommendations

In addition to disclaiming any duty to make structural recommendations, the intermediaries' agreements should shift the burden and risk associated with structural decisions entirely to the client and its lawyers or accountants who are acting in an advisory capacity.

Avoid Stock Sale Negotiations

Whether an unregistered intermediary should participate in any negotiations at all is problematical at best. Purporting to withdraw from negotiations only after a decision to sell or buy stock has been made carries considerable risk. All negotiations should be left to the parties and those of their advisers who have not participated in matchmaking. If there is a significant probability that an acquisition billed as an asset sale will actually close as a stock sale, the intermediary should confine its solicitations to prospects that the seller could solicit in an exempt, private placement. General advertisements and mass-mailings should be avoided in favor of personal or direct mail contacts with prospects with which the intermediary or another agent of the seller has a "preexisting substantive relationship." This will not help the intermediary with its registration problem. It may, however, mitigate somewhat the risk of civil liability to the buyer or to an innocent seller based on a claim that the seller's exemption from registration has been lost.[12]

Unbundle the Compensation and Separate it from Structure

Allocate compensation to discrete promotional, asset valuation and other permissible services to show that the compensation is not dependent on the form of the transaction. Transaction-based compensation is perfectly legal in an asset acquisition, but can be fatal in stock deals. To make the allocation easier, include a generous allowance for the fact that the compensation is contingent. Contingent compensation carries substantial and obvious risk. The acceptance of that risk should be rewarded. A selling client can shift an intermediary's compensation to the buyer by adding it to the price. A buying client can recoup such compensation in the price savings by which the intermediary presumably earned it. There should be little resistance to the notion that compensation for accepting risk need not be justified by other services.

Summary

Under current law, the duty to register as a securities broker arises when two conditions are met; first, an intermediary has "effected" a transaction in securities for the account of someone else; second, the intermediary has done so as part of a "business." In the *MuniAuction, Inc.* letter (Note 8), the SEC staff observed that participating "at key points" in the "chain of distribution" of securities is "effecting" transactions in them. "Participation" includes providing assistance in the structure or solicitation of securities transactions, the identification of potential purchasers or the taking of orders.

In a stock acquisition, "distribution" occurs at closing, but the "chain" culminating in that event begins much earlier and the factors cited by the SEC as requiring registration are clearly present, though labeled differently. Thus, structural assistance is provided by advising on the form of the acquisition. Soliciting bids is the acquisition equivalent of soliciting securities transactions. Potential purchasers of securities are "identified" as acquirers. Accepting bids is the acquisition equivalent of "taking orders."

Percentage commissions are the main source of revenue for business brokers and various incentive or performance fee arrangements are popular with other M&A advisers. The problem is that, apart from advertising, the principle factor suggesting the conduct of a brokerage business is transaction-based compensation. It is important, therefore, to remember that such compensation may require registration only in stock acquisitions brought about, or "effected," by the putative registrant. Matchmaking intermediaries should make the structure of the transaction a technical byproduct which is independent of the compensation scheme and which the intermediary neither initiates nor influences. Correspondingly, advisers who do influence structure should demonstrate that they are not also involved in matchmaking.

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[12] For a discussion of the prohibition against "general solicitation" in private placements, see this website, "Corporate Finance, Private Placements, Part II."