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

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

Once a dormant issue, the need for revision in securities licensure regulations for lower middle market M&A transactions 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 risk of rescission of M&A transactions. 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 legal action for rescission of the transaction for a period of several years. Conceivably, this could give business buyers "a free look" and "deal insurance" within the time parameters of the federal and state statutes of limitations dealing with securities transactions.

Securities law violations caused by financing with seller notes adds to the securities issues present when asset structured M&A transactions morph into stock structured deals. The licensure issue caught the eye of Congress and is now rising to the forefront in light of the introduction of HR 2274 – The Small Business Mergers, Acquisitions, Sales and Brokerage Simplification Act of 2013. If enacted, the legislation would instruct the SEC to simplify the registration for M&A Brokers to be more closely related to the nature of, and need for oversight of, privately negotiated M&A transactions. The legislation would also clarify the need for broker licensing and end the fear of rescission from unintentional violations of securities law.

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 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. 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.

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 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.

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, 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.

Addressing federal registration of M&A brokers has been a priority issue of the SEC's Annual Government–Business Forum on Small Business Capital Formation Program since 2006. See http://sec.gov/info/smallbus/sbforum.shtml.

It is clear that the SEC requires registration of business brokers working for buyers and sellers of businesses in mergers and acquisition when securities are involved. See 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 a multi-national public company.

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…”

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.

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. The Small Business Mergers, Acquisitions, Sales and Brokerage Simplification Act of 2013 begins to address the licensing issue. View the House bill at http://www.govtrack.us/congress/bills/113/hr2274/text?utm_campaign=govtrack_email_update&utm_source=govtrack/email_update&utm_medium=email

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 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.

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

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