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RISKY BUSINESS

A lack of clarity on licensing requirements has left small business brokers vulnerable to lawsuits, decreased commissions and even broken deals

by THOMAS ZADVYDAS

BUSINESS BROKERS ARE LOOKING for the guiding light of regulatory authorities to help them see through a legal fog.

Brokers are important intermediaries for the thousands of small businesses that are the pulse of the U.S. economy. These professionals, denizens of the low end of the M&A chain, use their negotiating skills to help Main Street entrepreneurs buy and sell establishments that are the essence

of American communities: barber shops, flower stands, restaurants and grocery stores; small construction companies; auto repair garages; and the like. However, they operate in a legally gray area, at least as far as regulations from the Securities and Exchange Commission are concerned. There is a lack of clarity concerning how business-broker transactions are legally defined and what licensure is required to perform them.

This has left brokers vulnerable to potential lawsuits, lowered commissions and broken deals by challenges to their legal qualifications to make transactions.

A March 2010 report from Chicago's Alliance of Professional Merger & Acquisition Advisors titled "Regulatory and Legal Issues Affecting Business Brokers" estimates

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that there are between 3,000 and 4,000 business brokers in the U.S. Some professionals in the field put the number higher. As middle-market deal activity continues to increase, the regulatory uncertainty surrounding these small business brokers will become a larger concern.

"We estimate that there are about 9,500 people involved in this; when the economy gets heated, that number will probably triple," said International Business Brokers Association, or IBBA, president Mark O. Thorsby in Chicago.

Mike Ertel, a business broker at Tampa, Fla.'s **Legacy M&A Advisors LLC** adds: "There is a lot of confusion on when you need to be securities-licensed and when don't you need to be. There are tens of thousands of people who are engaged in the brokering of businesses who have no idea that they could be running afoul of the securities laws because they don't see themselves as buying and selling securities." Ertel also serves as the co-chairman of the Alliance of Mergers & Acquisition Advisors' Securities Licensure Task Force, an advocacy group attempting to address this problem.

Federal securities law, as mandated in the Securities Act of 1933 and the Securities Exchange Act of 1934, under its strictest reading mandates that any person brokering an M&A deal where securities are included requires SEC licensure—including completion of the appropriate exams, such as the Series 7—and Financial Services Regulatory Authority membership, obtained either for themselves or through a Finra-affiliated broker-dealer. Also, either the individual broker or the Finra firm must register with every state where a transaction might take place.

The SEC is the federal agency charged with upholding and enforcing the 1933 Act, while Finra, founded in 2007, is a nonprofit independent regulator for the securities business and issues all relevant certifications for the finance industry. The broker definition is specifically found in Section 3 of the 1934 Act, and it is generally applied in any deal that involves a transfer of stock or any interaction with investors where securities might change hands.

Finra membership alone costs around \$5,000 a year. According to 2009 U.S. Census data, more than 99% of U.S. businesses generate less than \$50 million in revenue. A

cursory look at many brokerage sites shows list prices for businesses that may fall as low as \$100,000, and a broker might net only 10% or 12% of this in a sale.

"That's an expensive process, but it's the letter of the law," says Ertel. "The law as it's currently on the books makes no exception for the size of business. So whether I'm selling a two-chair shoe-shine stand or a privately held multibillion-dollar corporation,

that larger advisory shops higher up on the transaction chain use the strict statute reading as a coin machine.

"Somebody's going to tell you that a promissory note is a security, which is just a bunch of crap," says William Lange, a principal at San Diego-based Vanguard Resource Group, an affiliate of **VR Business Brokers**. "There's a lot of companies out there right now who are scaring bro-



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I would technically have to be registered if the transaction involved securities."

Ertel goes on to explain that even a straight asset sale might fall under this jurisdiction and thus require broker registration if a deal involves a seller's promissory note, for instance.

"It's not unusual for a broker to start with one form of financing between a buyer and a seller and end up with a very different form by the time you close the transaction, and this is where it gets a little hairy," says Thorsby. "It morphs into, 'Oh, I can't get all the financing I need, so the owner is going to retain 25% ownership in the business.' The way to secure the owner's interest is through [transferring] a share of stock."

The knowledge required for Series 7 and other designations is above and beyond common business brokerage activity, Thorsby says. "Do I really need to know about municipal bonds? Do I really need to know about puts and calls? Do I really need to know about hedge funds?" he asks.

Others take it a step further, believing

brokers to death, saying, "You're going to lose your shirt, get sued, the deal's going to get rescinded, but here's what [Finra-affiliated firms] can do for you. Pay us a big fee, be a part of our organization, and when you have a stock sale, let us handle it for a big chunk of the money, like 25% or 30%."

Though not a new issue, proper registration of broker-dealers has become more of an issue as business-broker activity increasingly turns up on the SEC's radar. In June 2005, the American Bar Association published a paper on the unlicensed-transaction market that caught the agency's attention. Nonetheless, the only piece of documentation that resembles anything close to legislation on the issue is something called an SEC no-action letter, which had originally appeared following a 1985 Supreme Court case—*Landreth Timber Co. v. Landreth*—after a request by **International Business Exchange Corp.** The letter itself is basically a request for an exemption

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from certain SEC regulations; the party in question typically writes the request with legal assistance and the SEC approves it.

The best-known recent example was in November 2006, when the IBBA filed such a letter on behalf of **Country Business Inc.** The letter does not discuss the specifics of the transaction in question, stating only that the seller with which CBI was working fits the definition of small business, as defined by the U.S. Small Business Administration. This document is important in that it gives a clear definition of business brokerage in a transactional sense: A broker merely transmits documents between parties, provides administrative support for a client, helps value the assets in question and prepares financial documents. In the case of CBI, the broker was not involved in a securities transfer of any kind, nor did it handle any of the money that changed hands.

“Any decision to effect the transfer of a business by means of a security sale will be made solely by the purchaser and seller without the recommendation of CBI,” the letter reads. The SEC subsequently approved an exemption from enforcement action, and it is generally believed that if a business brokerage sticks to these parameters it should avoid legal trouble.

As helpful as the no-action letter is as a guideline, it does have limitations. “It is only a no-action letter—not an interpretive release, not a rule and not an SEC order. Technically, it only has application to the recipient,” reads a memo from Shane Hansen, partner and co-chairman of the broker-dealer and investment adviser practice group at **Warner Norcross & Judd LLP**. The letter is also not binding in private civil litigation, addresses only sell-side engagements, can’t justify compiling of a loan package and allows only for cash compensation, Hansen wrote.

Because of the dim regulatory framework, brokers have been deprived of commission in some cases, and even had deals broken apart post-closing, based on claims that a business broker wasn’t properly licensed to do deals due to the broker’s murky position under securities statutes.

“I’m aware of cases where the broker has been threatened with the loss of all of his commission, and they’ve settled at some lower number just to make it go away and get something where timing is of the

essence,” Ertel says. The broker says he knows of at least three appellate cases—two in Florida (*Fisch v. Radoff* in 1978, and *Edelstein v. Flanagan* in 1994), and one in Texas (*Vero Group v. ISS-International Service System* in 1992)—where this issue has been litigated. In each case, the brokerage was denied compensation on a deal because it allegedly lacked proper licensing, but ultimately won in court.

“The courts ruled that even though the deals turned out to be a securities transaction, the broker did its job—the finding of buyers and sellers for businesses—so in these [rulings, the brokers] didn’t come under the rules and didn’t need to be registered in the first place,” Ertel says.

AS FAR AS RECENT cases go, one source who declined to be named identified a business broker in Nevada who’s facing a \$250,000 lawsuit because of a claim that the individual wasn’t properly licensed to effect a securities deal. The defendant in question, Len Krick, claims that the law doesn’t apply and is using parts of the 2006 SEC no-action as the basis for his defense.

To avoid the legal headache, independent brokers could work for a Finra-affiliated firm, of course. However, such a move would be a loss of autonomy, and a surrendering of long-held independence, say some brokers.

“There’s no way I’m working under any other firm, I could tell you that right now. I’ve owned my company all [its] life,” says Mel Lisiten of New York business brokerage **Lisiten Associates**, in business since 1982. Lisiten, who sells small businesses like shops, hotels, and other real estate, says as he understands it, most of his firm’s transactions in any case fall outside the domain of securities law, and as such, Finra registration and securities licensing would be an unnecessary burden.

“The contracts that we use are simple business agreements, they’re simple purchase and sale agreements, they’re not stock agreements, so it really doesn’t come into that category. I can’t imagine that it would, unless in the future I do make a stock sale,” he says. In that case, Lisiten says he would engage a formally licensed Finra firm. “I could still own Lisiten Associates, and any deals that fall under [a stock] category I could put through a broker-dealer and pay

him a percentage for handling the transaction for me, but I don’t have to change my status.”

Other brokerages, believing that working for a Finra-affiliated firm increases their capabilities, have struck more formalized partnerships. Scottsdale, Ariz., business brokerage **Premier Sales Inc.** announced on Jan. 26 that it had formed a strategic alliance with financial adviser and merchant bank **WCP Advisors Inc.**, also of Scottsdale. WCP, which does business as Windstone Capital Partners, is Finra-registered through an affiliate, William. H. Murphy & Co.

The idea behind the partnership was to gain direct access to the capital markets and greater transaction capability for the Arizona shop, says Diane Thomas, Premier’s owner.

“There are conversations and ways of looking [toward] further regulation. We believe the size of the transactions and the complexity of the transactions we’ll be doing in the future [will increase], she says. [The deal is] starting to lay the groundwork for our greater regulatory compliance.”

Thomas, whose firm handles sales of small construction companies and professional service shops like accounting firms, notes that before the pact with Windstone, Premier’s business was limited. “We had to decline a lot of transactions. If [a potential client] was a publicly traded company, or someone that had gotten a private placement, we suggested they engage a different firm,” she says. “If they had legal counsel and identified a role for us that was strictly on a consulting basis, then we would engage in some capacity.”

Thomas explains she was afraid of inadvertently violating securities laws. “I just wouldn’t step over the line,” she says.

The SEC, which declined to comment for this story, is aware of this regulatory thornbush, but has more pressing concerns, mainly, implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law on July 21.

“They’ve said they just aren’t going to get to our issue anytime soon because they’ve got too much to keep up with the obligations that Dodd-Frank has imposed,” says Ertel.

Or, as Thorsby bluntly puts it, “They’ve got so many other fish to fry.” ■