

Regulatory and Legal Issues Affecting Business Brokers

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Introduction

A Business Broker is generally defined as a person who assists individuals in selling or buying a small business. The activities of a business broker can range from simply putting two parties together for a transaction to more complicated functions such as analyzing a business's financial statements, marketing the business for sale, and assisting in negotiations and terms of a transaction¹. It is estimated that there are approximately 3,000 – 4,000 business brokers in the U.S. alone. A business broker is often utilized by smaller firms looking to sell that are not large enough to attract the interest of traditional investment banks. Most investment banks work on transactions with companies generating in excess of \$100 million dollars in revenues. An analysis of U.S. companies by size reveals that over ninety-nine percent of businesses generate less than \$50 million in annual revenues². It is this large, underserved market that business brokers traditionally focus on, assisting companies ranging from local flower shops to small regional distributors.

In general, the field is not highly regulated, but the wide range of activities that business brokers engage in can subject them to many national and state regulations³. The most common regulations that business brokers encounter are national securities laws and state level real estate laws. The financial crisis of 2008 has increased the profile of business brokers and heightened the scrutiny of regulatory bodies over their activities. Presently, there is debate and confusion as to what activities business brokers can perform and what licensure, if any, is required of business brokers to be in compliance with applicable laws⁴.

¹ Johansen, John A. (1991).

² United States Census Bureau (2009).

³ Brown, Russell L. (2002).

⁴ Task Force on Private Placement Broker-Dealers, ABA Section of Business Law (2005, June).

U.S. Federal Regulations

The United States legislature created the Securities and Exchange Commission (“SEC”) after the stock market crash in 1929. Its mission includes protecting investors by requiring disclosure in financial transactions and regulating market activities. The SEC oversees and has enforcement authority against the activities of securities brokers. The Securities Exchange Act of 1934 defines a broker as “any person engaged in the business of effecting transactions in securities for the accounts of others⁵.” The security brokers themselves are licensed by the Financial Industry Regulatory Authority (“FINRA”); a Self Regulatory Organization (“SRO”)⁶.

When a business broker assists in selling a company, the actual legal form of the transaction takes place as either a stock purchase or an asset purchase. Although the business broker’s services and activities may be the exact same in both instances, the legal structure of the transaction has a significant effect on the regulations overseeing the broker. If the contemplated transaction is completed as a stock sale, federal security laws are usually applicable. It is this form over substance that moves the business broker’s activities from an unlicensed to licensed role at the national level.

Published SEC guidelines suggest that it determines whether or not someone needs to register as broker-dealer depending on several factors. Specifically, three key areas are looked at: one, does the person involved participate in any important parts of the transaction including solicitation or negotiations of the transaction; two, is any of the compensation transaction-based;

⁵ Makens, Hugh H. & Hansen, Shane B. (2009, September, 14).

⁶ Cornell, Jim and Ertel, Mike and Hansen, Shane. (2009, September 18).

and three, did the person handle any securities or funds of any party to the transaction. If the answer to any of these issues is “yes” then the SEC cautions that the person is most likely considered a broker-dealer and needs to register⁷. Although a business broker does not normally handle funds, they do play an integral part of the transaction, as defined by the SEC, and normally receive transaction-based (success fee) compensation. These two key elements in a stock based transaction make the business broker subject to federal securities licensure and regulations.

One solution would be for all business brokers to obtain a securities license issued by FINRA. Unfortunately, this solution is viewed by business brokers as both cost prohibitive and not applicable to the primary functions they perform. Since FINRA broker-dealer registration is available only to firms and not individuals, every business broker would need to both obtain a Series 7 General Securities license and then work under a registered broker-dealer. From a cost perspective, the compliance, financial qualifications, and regulatory knowledge needed to maintain a broker-dealer license is not feasible for individuals and small firms working on small transactions⁸. From a functional stand point, business brokers typically effect transactions between an active owner operator and a single or small number of active buyers; i.e. a new owner. The Series 7 license testing and regulations primarily revolve around retail stock broker activities which include handling funds from passive investors who are acquiring shares in a company where the profits are derived from the activities of others.

Both FINRA and the SEC have recognized that the current regulations were not designed to address the activities of business brokers and that current registration requirements may pose

⁷ Task Force on Private Placement Broker-Dealers, ABA Section of Business Law (2005, June).

⁸ Makens, Hugh H. & Hansen, Shane B. (2009, September, 14).

an undue burden on brokers while depriving small businesses with much needed services. The SEC's staff of the Division of Market Regulation has provided its views regarding various aspects of securities laws and regulations and when it would consider enforcing the regulations through a series of "no action" letters; i.e. when it would recommend *not* to take any enforcement action even though there may be a technical violation of a regulation or law.

The most relevant no action letter relating to business broker activities is Country Business, Inc. issued by the SEC in November 2006⁹. In its letter, the SEC outlined the specific circumstances where a business broker would not have to register as a broker dealer if it assisted in the sale of a company's stock. Specific requirements include; the company being sold is a going concern; only assets are advertised for sale and consequently if the transaction is structured as a stock sale, it would convey all of the business equity securities to a single purchaser or small group of purchasers; compensation is determined prior to the decision on how to effect the sale; and the business satisfies the size standard for "small business" pursuant to the U.S. Small Business Administration. It should be noted that no action letters are written as a specific response to a specific set of circumstances and they do not protect a person or firm from being held liable in a civil suit but they do have the effect of creating a safe harbor for limited activities of business brokers.

The financial crisis of 2008 saw an increased call for oversight of financial institutions. In March 2009, FINRA proposed a new Investment Banking Professional (Series 79) license that would more closely align education, testing, and oversight with activities relating to buying and selling a business and other traditional investment banking activities¹⁰. The SEC acted quickly

⁹ Bussey, Brian A. (2006, November 8).

¹⁰ Financial Industry Regulatory Authority, Inc. (March 2, 2009).

on this new proposal and approved it on April 13, 2009. The new rule is effective November 2, 2009. This new classification has been met with skepticism from the business broker community since the new FINRA classification specifically defines activities requiring licensure to include “advising on or facilitating mergers and acquisitions...assets sales...or business combinations.”¹¹ Although this may seem contrary to the SECs position, FINRA regulations only apply to FINRA members. With the new license instead of a broker-dealer firm’s investment banking professional being required to obtain a Series 7 general securities license, they will now be able to perform their duties with the more applicable Series 79 investment banking license. Non-FINRA members; i.e. business brokers can still perform their activities based on guidance from the SEC no-action letters.

U.S. State Regulations

Every U.S. state has regulations and laws surrounding the activities of security brokers. Again, if a business broker effects a transaction through stock purchase there is the strong likelihood that security regulations apply. Security brokers are required to obtain state licensure in the states where they sell securities. Contrary to the federal “no action” position for small stock transactions, some states such as Utah, have taken the position that regardless of size, if a business broker assists in effecting a stock transaction, they would be deemed a broker-dealer under the state security laws¹².

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¹² Woodwell, Keith (2009, May 7).

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A real estate license is required in all 50 states to represent real estate for sale¹³. There are three basic approaches that states have taken in addressing business brokers in their real estate statutes: one, not addressing at all; two, specifically requiring a real estate license if the transaction involves real estate; and three, requiring a real estate license for business brokerage activities regardless if real estate is involved in the transaction.

In the first example where business brokerage activities are not addressed in the statutes, business brokers involved in asset transactions that do not encompass the transfer of real estate would not require a real estate license. Many business brokers incorrectly assume that every small business transaction involves some form of real estate and hence every business broker requires a real estate license. Experienced business brokers understand that many business transactions can take place without any real estate transferring hands. Examples of such transactions include service oriented or technology businesses where the primary assets sold are customer lists or patented technology.

Even when the statutes specifically state a real estate license is needed only if real estate is involved, there still seems to be confusion among the business brokerage community. As an example, the Georgia Association of Business Brokers states on their website that all Georgia business brokers are required by law to have a real estate license¹⁴. The Georgia Real Estate Commission and the Georgia state statutes are quite clear that a business broker must hold a real estate license only if the sale of the business involves the transfer of any interest in real

¹³ Brown, Russell L. (2002).

¹⁴ Georgia Association of Business Brokers. (2009).

property¹⁵. This position was confirmed by the author (via phone and e-mail) with the Georgia real estate commission on February 10, 2009.

It is the third category of states that require a real estate license for business brokerage activities, regardless if real estate is involved, that business brokers need to be aware of. The reason real estate laws apply in these states is due more how the state statutes define "real estate" rather than if real estate is actually involved in the transaction. Some, such as Florida, specifically define real estate to include: "any interest or estate in land and any interest in *business enterprises or business opportunities*¹⁶." The consequences of unlicensed activity can be very serious; in Florida, performing unlicensed real estate activities is a felony.

Michigan real estate regulations are written similar to Florida, requiring a business broker to gain a real estate license in order to assist people in buying and selling businesses. In 2003, this law was challenged in *Timmis & Company V. Guardian Alarm Company*. Guardian acquired the assets of a company, excluding any real estate, with the help of Timmis who acted as a business broker. Guardian refused to pay a fee to Timmis on the grounds that Timmis was not a licensed real estate broker as required by law. It was the opinion of the Supreme Court of Michigan that a real estate license was not required since the exchange of the business did not include an interest in any real estate¹⁷. The Court went on to say if the legislature wanted to specifically regulate business brokerage activities, they could introduce legislation to do so.

As a side note, most states have exclusions from real estate laws for the sale of businesses when real estate is involved as part of the transaction if the person is licensed at the national

¹⁵ Georgia Real Estate Commission. (2009).

¹⁶ Florida Legislature, The. (2009).

¹⁷ State of Michigan. (2009.)

level, i.e. a securities broker. Additionally, if a transaction involving a real estate lease is closed with the use of an attorney who handles the closing documentation including lease transfers, new lease negotiations, etc., it could be argued that a real estate license was not necessary since the broker was not involved in a real estate transaction and attorneys are allowed to prepare and negotiate leases as part of their normal course of legal services.

Most literature list approximately 19 states that require a Real Estate License to sell businesses. To test the validity of this list, a sampling of twelve states was chosen for review. Based on a review of each states real estate regulations in place at the time of this report, as illustrated below, it appears that the generally accepted list of states requiring a real estate license is not accurate.

Summary of State Licensure Findings

State	License	Comments
CA	Yes	Specific in statues.
FL	Yes	Specific in statues.
IL	Yes	No RE license but Business Broker Registration required by state.
MN	Yes	Called and confirmed.
WI	Yes	Email confirmtaion.
AZ	No	Confirmed via phone and emial with Department of RE
GA	No	Confirmed via phone and emial with Department of RE
MI	No	In statues but MI Supreme Court over rulled.
NV	No	In statues but verbal no via phone and email from Dept. if no RE involved.
OR	No	Not in statues.
UT	No	Not in statues.
WA	No	Confirmed by email from Department of RE.

*As of 1/1/10.

This list is not meant to be all-inclusive and it contains the findings and opinions of the of the author. If you have a question on your states regulations, you should consult an attorney familiar with your specific state. State regulations and interpretation are constantly changing. The Appendix contains an example of the email used to confirm the findings. Changing the specific question made to the state could result sin substantially different results.

International Regulations

A review of international laws finds that most major nations require the licensure of security brokers. A case analysis of the applicability and enforcement of these regulations to the activities of business brokers was not conducted. As in the United States, for smaller asset based transactions, many countries have incorporated oversight of business broker activities into their real estate regulations.

In New Zealand business broker activities are addressed similar to U.S. states that regulate activities under real estate law. The New Zealand Real Estate Agents Act of 2008 specifically defines a real estate transaction to include “the sale, purchase, other disposal or acquisition of any business (either with or without any interest in land)¹⁸.”

Recognizing the need to both codify and regulate the activities of business brokers, Australia addressed the activities of business brokers in The Real Estate and Business Agents Act of 1978. The law separates the activities of real estate agents and business agents. The law required any person involved in a defined business transaction to have a Business Agent license. The act defines a “business transaction” to include:

“a sale, exchange or other disposal and a purchase, exchange or other acquisition of a business in any shares or interest in a business or other goodwill there of¹⁹.”

Canada real estate laws are enacted at the provincial and territorial level. In British Columbia, the Real Estate Services Act of 2004 addresses activities requiring a provincial real

¹⁸ Parliament of New Zealand. (2008).

¹⁹ Government of Australia. (2009).

estate license²⁰. No where in the text does it reference the sale of businesses or goodwill and it appears that basic business brokerage activities would not require a real estate license if a transaction did not involve real estate. Saskatchewan takes an approach similar to many U.S. states that effectively require a real estate license for business brokers. According to *The Real Estate Act*, Saskatchewan statutes define “real estate” to include “...any business with premises...²¹.” Based on this limited review, it appears that in Saskatchewan a business broker would require a real estate license regardless if real estate was involved in the transaction.

Foreign laws can have an impact on domestic business brokers regardless of the country of practice. As an example, it is foreseeable that a Canadian company might want to engage a U.S.-based business broker to help market their company for sale to prospective buyers in the United States. This scenario also seems highly likely in the European Union (EU) with its high concentration of “neighbor” states. A U.S. based business broker wanting to service a Canadian client would need to understand Provincial regulations to determine whether or not they would be in violation of local laws. Unfortunately, a review of EU member state regulations was beyond the scope of this report.

Conclusions

Business Brokers need to be aware that in addition to their activities, the legal structure of the transactions they work on can subject them to various federal and state laws. In the U.S., for stock-based transactions business brokers should recognize that the SEC has never "approved" the unlicensed activity of business brokers or said that these activities are not in violation of

²⁰ Lieutenant Governor in Council of British Columbia (2009, March 6).

²¹ Government of Saskatchewan. (1995).

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current federal securities laws. What they have done is issue no action letters that state they "will not proceed with enforcement actions under a specific set of guidelines."

At the U.S. level, business brokers involved in asset transactions that do not encompass the transfer of real estate generally do not require a real estate license, although laws do vary by state. In every state, if the business broker is involved in a transaction that involves the transfer of real estate, the broker would require a real estate license.

The vast reach of internet based advertising has increased the opportunity for business brokers to expand their service offerings internationally. International regulations regarding security based transaction are generally highly regulated but as in the U.S., laws covering small asset based transactions vary from country to country and are typically regulated at the territorial, provincial, or appropriate municipal level. Hence, this new opportunity is not without a cost since an understanding of foreign regulations is necessary for business brokers to be in compliance with applicable local laws.

Appendix

From: Jan Holle [jholle@red.state.nv.us]
Sent: Thursday, February 05, 2009 2:48 PM
To: Greg Dupuis
Subject: RE: Real Estate Licensure Question

As long as the "business" does not include the sale or leasehold of property, then a Nevada Real Estate license and business broker permit is not required. The Nevada Real Estate Division is unaware of any other state, county, or local licensing requirements for conducting such a transaction in Nevada.

Mr. Jan R. Holle
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From: Greg Dupuis [mailto:gdupuis@bridgeventuresllc.com]
Sent: Thursday, February 05, 2009 11:29 AM
To: Jan Holle
Subject: Real Estate Licensure Question

To whom it may concern,

I called the Nevada Division of Real Estate this morning to address a question regarding real estate licensure. Specifically,

- 1) I live in Florida and am a business broker (helping individuals sell their companies).
- 2) I advertise in trade publications and will periodically receive calls from companies out of state requesting my services.
- 3) If I am contacted by a NV based company, may I assist them in selling their business without having a NV real estate license if there is NO real estate involved in the transaction?

I was told on the phone that as long as no real estate was involved I would not need a NV license, but if possible, I would like to get confirmation of this.

Your assistance is greatly appreciated. If you have further questions, please do not hesitate to contact me.

Thanks,

Gregory L. Dupuis
President

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