SUMMARY OF MEMORANDUM DISCUSSING CHANGES IN BUSINESS BROKER LAWS

1. Because of developments in Michigan law, a question was asked whether a Business Broker who is not a licensed Securities Broker/Dealer is legally permitted to participate in merger and acquisition of small businesses involving purchase or sale of company stock.

   The answer is that a Broker may participate in the purchase and sale of company stock and receive a success fee on the following conditions:

   A. The Broker is acting as a "Finder."

      1. A Finder is someone who participates in transaction by locating, introducing, or referring a potential purchaser or seller.
      2. This includes real estate incidental to business purchase or sale.
      3. The problem is applying the legal definition of "Finder" to real life situations, because it is not clear how much the Finder may do.

   B. The Broker fall under definition of Merger and Acquisition Broker.

      1. A Broker who is engaged in the purchase or sale of company stock solely in connection with transfer of ownership of an eligible privately held company if both of the following conditions are met.

         i. The purchaser will be active in the business management.
         ii. Purchaser must have access to most recent fiscal year end financials.

      2. A Merger & Acquisition Broker may not.

         i. Control fund or securities.
         ii. Engage on behalf of publicly traded co.

      3. A Merger & Acquisition Broker may not have been subject to sanction for violation of securities laws.

Real Estate

A Finder or a Merger & Acquisition Broker may be involved in the purchase or sale of real estate if it is as a Finder or the purchase or sale is in connection with a purchase and sale of a company.

M E M O R A N D U M

To: Wendell Brandt

From: Robert J. Hahn

Date: 5/18/2022

Re: Sale and Purchase of Company Through Stock Transactions.

PURCHASE AND SALE OF SMALL BUSINESS

ISSUE: Whether a Michigan business broker who is not a federally licensed broker/dealer may receive a "success fee" in the merger and acquisition of small business involving the purchase and sale of some or all of a company stock.

RULE: The Michigan Department of Licensing and Regulatory Affairs, Corporations, Securities, and Commercial Licensing Bureau has issued rules setting standards which permit a business broker to receive payment in merger and acquisition transactions involving purchase and sale of stock in small companies, and such business brokers need not be registered as broker/dealers under federal securities laws.[1]

BACKGROUND: Historically, Michigan courts have held that the purchase and sale of a small business involving company stock, rather than a transaction involving a purchase and sale of

[1] The Department of Licensing and Regulatory Affairs Corporation, Security, and Commercial Licensing Bureau, issues rules by authority conferred on the Director of the Department of Licensing and Regulatory Affairs pursuant to the Uniform Securities Act, MCL 451.2201, 451.2202, 451.2202(a), 451.2203, 451.2304, 451.2306, 451.2401, 451.2403, 451.2405, 451.2406, 451.2410, 451.2411, 451.2412, 451.2502, 451.2504, and 451.2605, and Executive Reorganization Order No. 2012-6, MCL 445.2034.

assets, was subject to securities laws requiring a business broker to be a registered broker/dealer in order to receive compensation for facilitating the purchase and sale transaction.

The United States Supreme Court has held that a transaction involving the transfer of 100% of the stock of a closely held business involved the sale of securities within the meaning of federal securities laws. *Landreth Timber Co. v. Landreth*,[2] and in a companion case held that transfer of 50% of the stock of a closely held corporation also involved sale of securities. *Gauld v. Ruefenacht*[3]. If the transaction were structured as an asset purchase and did not involve sale of securities, a person could broker the transaction without registration as a broker/dealer.

The problem is that the sale of assets may not be in the best interest of the parties to the transaction compared to a sale of company stock for tax reasons, or because sale of stock may permit a higher sale price than a transaction involving only an asset sale.

SEC No Action Letter.

On January 31, 2014, the Securities Exchange Commission ("SEC") issued a No Action Letter [4] which stated that on certain conditions, a merger and acquisitions broker could advertise and participate in securities transactions in connection with the purchase and sale of a privately held company and the SEC would not take enforcement action if all conditions were satisfied. These conditions were:

1. M&A Broker will not have ability to bind the parties to the transaction.
2. M&A Broker may not provide financing for the transaction.
3. M&A Broker may not take custody, control or handle funds or securities.

[2] *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985).
[3] *Gauld v. Ruefenacht,* 471 U.S. 701 (1985).
[4] U.S. Securities & Exchange Commission No Action Letter, January 31, 2014. Re: M&A Brokers.

4. M&A transaction may not involve public offering.
5. If M&A Broker represents buyer and seller this must be disclosed, parties must consent.
6. M&A Broker may not form a group of buyers.
7. The buyer must have control and actively operate business after purchase. Control is presumed if a party may vote 25% of stock, can sell 25% of voting stock, or in a limited partnership, has right to receive 25% of capital.
8. M&A transaction will not result in transfer to passive buyer.
9. Securities received by buyer are restricted stock under federal law.
10. M&A Broker has not been subject to SEC discipline.

The problem with the "No Action" letter was that while it set guidelines under which the SEC would not take enforcement action against an M&A Broker, it was case specific and did not change existing law. In other words, while it provided guidance to the business broker community, it was not binding and parties to a transaction relied on the No Action Letter at their own risk.

MICHIGAN LAW:

In 2019, the Michigan Department of Licensing & Regulatory Affairs issued rules under authority of the Michigan Securities Statutes designed to resolve questions in a fashion similar to the SEC No Action Letter of 2014. Relevant sections of these rules are as follows. IMPORTANT: This applies only to the State of Michigan. While several states have adopted similar laws, not all states have addressed the issue. Check each State's law if you are operating across state borders.

"FINDER" EXEMPTION:

Rule 1.2 provides that "Broker/Dealer" does not include a "Finder" as that term is defined by the Uniform Securities Act, MCL 451.2102(1). A "Finder" is a person who, for consideration, participates in the offer to sell, sale, or purchase of security, by locating, introducing, or referring potential purchasers or seller. A person who limits his or her activities to those described in the statutory definition of "Finder" under the State Securities Act is exempt from the Acts registration requirements. MCL 451.2102(i), Mich. 451.2406(1).

This rule is further important because it opens the opportunity for a Business Broker to participate in real estate purchase and sale, if the Finder's role is limited, and the transaction of real property is incidental to the sale of a business.

The problem with the definition is that it is hard to apply to an actual transaction. The typical Finder does more than just find and introduce the prospective Buyer to the Seller. The question then becomes how much more can the Finder do without violating requirements to register as a Broker/Dealer. While not stated in the statutes, rules, or in case law, it appears that the State of Michigan adoption of rules governing Merger & Acquisition Brokers addresses these concerns by more carefully defining what is permitted and what is prohibited.

MERGER AND ACQUISITON BROKER EXEMPTION:

Rule 4.2(1). The following definitions apply for purposes of this rule:

(a) "Control" means the power to directly or indirectly direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise. There is a presumption of control for a person who meets any of the following:

i. Is a director, general partner, member, or manager of a limited liability company, or officer exercising executive responsibility, or has similar status or functions.

ii. Has the right to vote 20% or more of a class of voting securities or the power to sell or direct the sale of 20% or more of a class of voting securities.

iii. In the case of a partnership or limited liability company, has the right upon dissolution to receive, or has contributed, 20% or more of the capital.

(b) "Eligible privately held company" means a company meeting both of the following conditions:

i. The company does not have any class of securities registered or required to be registered with the SEC pursuant to Section 12 of the Security Exchange Act of 1934, 15 USC 781; or, with respect to which a company files, or is required to file, periodic information, documents, and reports pursuant to Section 15(d) of the Security Exchange Act of 1934, 15 USC 780(d).

ii. In the fiscal year ending immediately before the fiscal year in which the services of the merger and acquisition broker are initially engaged with respect to the securities transaction, company meets either or both of the following condition:

(A) The earnings of company before interest, taxes, depreciation, and amortization are less than $25,000,000.

(B) The gross revenues of the company are less than $250,000,000.

(c) "Merger and Acquisition Broker" means a broker and a person associated with a broker engaged in the business of effecting securities transactions solely in connection with the transfer of ownership of an eligible privately held company, regardless of whether the broker acts on behalf of a seller or buyer, through the purchase, sale, exchange, issuance, repurchase

or redemption of, or, a business combination involving securities or assets of the eligible privately held company if both of the following are true:

i) If the merger and acquisition broker reasonably believes that upon consummation of the transaction, all persons acquiring securities or assets of the eligible privately held company, acting alone or in concert, will control and be active in the management of the eligible privately held company or the business conducted with the assets of the eligible privately held company. (underline added).

ii) If a person is offered securities in exchange for securities or assets of the eligible privately held company, then before becoming legally bound to consummate the transaction, the person will receive or have reasonable access to the most recent fiscal year-end financial statements of the issuer of the securities as customarily prepared by its management in the normal course of operations and, if the financial statements of the issuer are audited, reviewed, or compiled, any related statement by the independent accountant, a balance sheet dated not more than 120 days before the date of the exchange offer; and, information pertaining to the management, business, result of operations for the period covered by the foregoing financial statements, and any material loss contingencies of the issuer. (underline added).

(2) A merger and acquisition broker is exempt from registration as a broker/dealer pursuant to MCL 451.2401, except as provided in subrule (3) and (4) of this rule.

(3) A merger and acquisition broker is not exempt from registration pursuant to the rule if the merger and acquisition broker does any of the following:

(a) Directly or indirectly, in connection with the transfer of ownership of an eligible privately held company, receives, holds, transmits, or has custody of the funds or securities to be exchanged by the parties to the transaction.

(b) Engages on behalf of an issuer of a public offering of any class of securities that is registered or required to be registered with the SEC pursuant to Section 12 of the Security Exchange Act of 1934, 15 USC 781; or with respect to which a issuer filed or is required to file periodic information, documents, and reports pursuant to Section 15(d) of the Security Exchange Act of 1934, 15 USC 780(d).

(4) A merger and acquisition broker is not exempt from registration pursuant to this paragraph if a merger and acquisition broker is subject to any of the following:

(a) Suspension or revocation of Broker/Dealer registration pursuant to Federal Securities laws

(b) A statutory disqualification as Broker/Dealer pursuant to Federal Securities laws.

(c) A disqualification under SEC Rule 506(d) of Regulation D.

COURT INTERPRETATION:

The Michigan Court of Appeals decided the case of *Pransky v Falcon Group Inc*. [5] in June of 2015. The case was decided based on the law governing Finders, before the State adopted rules permitting a Merger and Acquisition Broker to buy and sell eligible privately held companies, but it provides guidance to what is permissible. In that case a client filed a lawsuit against a consultant for recission, misrepresentation/silent fraud, breach of the State Securities Act and conversion. Plaintiff Jaime Pransky claimed that she entered into a Consulting Agreement with the Falcon

[5] *Pransky v Falcon Group Inc*., 311 Mich. App. 164, 874 NW2d 367 (2015).

Group who promised to find investors, and introduced her to an investor who told her that he would invest $20,000,000 in her business. The Court of Appeals held that the consultant did not have to register under State Securities Act to perform under the contract and thus the agreement was not illegal.

The dispute in the *Pransky* case was over the validity of the consulting agreement in relation to the scope of consultant's agreement to find investors for Pransky's business. The Falcon Group represented that it was "in the business of providing non-legal advice and consulting services to individuals and to business entities concerning, among other matters: mergers and acquisitions, marketing techniques and ideas, business opportunities, business operations, business management, financial issues and concerns, and business assets and liabilities." The agreement primarily involved compensation to the Falcon Group for its efforts to obtain investment for financing of Pransky's business.

The *Pransky* court held that one can provide general advice concerning mergers and acquisitions, marketing, business opportunity and operations, business management, financing and assets and liabilities without becoming involved in an activity regulated by the State Securities Act. The court said that the agreement requiring the consultant to provide its services in connection with identifying and procuring investors and financing for clients did not require the consultant to provide services beyond that of serving as a Finder under the Securities Act, and thus the consultant could perform under the agreement as a Finder without having to register under the Act. The court further held the agreement was not on its face illegal under the Act because the contract did not require the consultant to provide advice regarding the value of securities, or the advisability of

investing in, purchasing, or selling securities, or otherwise serving as a financial planner, and the parties had specifically agreed that they did not intend to establish an agency relationship and there was nothing in the agreement suggesting that the consultant would serve as a representative for a broker/dealer. [6]

REAL ESTATE

The sale of a small business often involves the sale of the building and property where the business is located.

ISSUE: Whether a business broker who is not a licensed real estate broker can receive compensation for the purchase or sale of real estate, where the real estate is part of a transaction for the purchase or sale of a small business.

RULE: MCL 339.2501(d) provides "real estate broker" means an individual or entity who with the intent to collect or receive a fee, compensation or valuable consideration, sells or offers for sale, buys or offers to buy, provides or offers to provide market analysis, lists, or offers or attempts to list, or negotiates the purchase or sale or exchange or mortgage of real estate, or negotiates for the construction of a building on real estate; who leases or offers or rents or offers for rent real estate for the improvement on real estate for others, as a full or partial vocation; who engages in property management as a full or partial vocation; who sells or offers for sale, buys or offers to buy, leases or offers to lease, or negotiates the purchase or sale or exchange of a business, a

[6] Note that the *Pransky* decision was issued before the Bureau of Licensing & Regulatory Affairs issue rules in 2019. *Pransky* relies on statutory definition of Finder.

business opportunity, for the goodwill of an existing business for others; or who as owner or otherwise engages in the sale of real estate as a principal vocation.

COURT INTERPRETATION:

The case of *GC Timmis and Company v Guardian Alarm Company*[7] involved a matter where an investment firm brought an action against a company that purchased assets of a third party business, alleging breach of an oral contract providing that the investment firm would receive a "success fee" for any business it contacted on behalf of the acquiring company, that the acquiring company subsequently purchased.

The Michigan Supreme Court held that the Real Estate Brokers Act ("REBA") is limited to transactions involving real estate and REBA does not require one to be a licensed real estate broker when one merely performs a usual function of a real estate broker, such as "finding" a purchaser. This decision abrogates prior case law. The *GC Timmis* court held:

1. Real Estate Brokers Act is limited to transactions involving real estate. MCL 339.2501.
2. Under definition of real estate broker in the Real Estate Broker's Act (REBA), one must only be a licensed real estate broker when, for a fee, one sells or buys real estate or negotiates a real estate transaction for another; REBA does not require one to be a licensed real estate broker where one merely performs a usual function of a real estate broker such as "finding" a purchaser.

The decision of the *GC Timmis* case is not a model of clarity and creates questions which it does not answer. In that regard, a review of subsequent court decisions interpreting the Supreme Court's

[7] *GC Timmis and Company v Guardian Alarm Company*, 468 Mich. 416 (2003).

language in *GC Timmis* can provide guidance to what is permissible and what is not. Unfortunately, the issue remains largely unresolved.

The case of *D.O.N.C. v. BPH Michigan Group, LLC*[8] was decided by the U.S. District Court, Eastern District of Michigan, Southern Division, in January 2022. The D.O.N.C. court addressed the question of whether D.O.N.C., who is not a licensed Real Estate Broker, could claim a commission where the contract between the parties required D.O.N.C. to assist in the sale of 100 Detroit properties. BHP argued it was not liable because D.O.N.C. is not a licensed Real Estate Broker, and is thus barred by statute from claiming payment. Because the contract required D.O.N.C. to participate in entire selling process, the court declined to decide the issue, and ordered the matter must go to trial. In other words the issue is not resolved by this case.

CONCLUSION:

Recent changes in Michigan law have expanded business opportunities for Merger & Acquisition Brokers. Because these developments are recent, there has not been time for court interpretation, meaning Brokers should be careful in their transactions until the business community has a better understanding of how the laws work. Careful compliance will be necessary as we explore new opportunities.

[8] *D.O.N.C. v. BPH Michigan Group, LLC (January 14, 2022) 2022 WL 138643.*