

ORANGE COUNTY BUSINESS JOURNAL

California Rescission Rights for Transactions Involving Unlicensed Broker-Dealers

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California Corporation Code Section 25501.5 is a little known code section that may have major implications for merger and acquisition transactions and for early stage companies seeking initial funding. This code section became effective January 1, 2005 and provides (i) rescission rights to a buyer who purchases securities from or through an unregistered broker dealer or unlicensed intermediary who is not a mere finder or (ii) the ability to recover monetary damages if the purchaser no longer owns such securities. If the investor no longer holds the securities, such investor may sue for damages, including attorney's fees, costs and treble damages up to \$10,000.

Why is this a problem?

Early-stage companies or funds seek funding from investors frequently with the assistance of intermediaries. Similarly, intermediaries are often used in connecting a buyer and seller of a company. In the event these intermediaries are more than a finder and are not properly licensed and receive compensation, California Corporation Code Section 25501.5 can trigger a rescission right or a claim for damages. Repeatedly, we have seen transactions involving individuals or entities seeking to receive fees that are not finders and are unregistered broker-dealers.

What is a finder?

A non-statutory exemption from the licensing requirements exists for individuals acting as finders. There is not a bright-line standard to determine whether or not an individual is a finder; instead, authorities weigh several factors. These factors include (i) the level of services a finder is providing to a company and potential investors, (ii) the regularity in which a finder is engaged in the business of facilitating investments between companies and investors, and (iii) compensation received by a finder for his actions in the investment.

What is a broker-dealer?

Under federal securities laws, a broker is any person engaged in effecting transactions in securities for others. California law is very similar and defines a broker-dealer as any person engaged in the business of effecting transactions in securities in California. Under both federal and California law, if deemed a broker, an individual is subject to certain licensing and other regulatory requirements.

• Level of services

In determining whether an individual is a broker-dealer, authorities will consider the level of involvement the individual has in the transaction. To avoid the unlicensed broker-dealer label, a finder should do no more than make introductions between the company and the investors and avoid all involvement in negotiations between the par-

ties. This factor was stressed in the first no-action letter issued by the SEC that recognized the finder exemption. In the Paul Anka no-action letter issued in 1991, the SEC found that an individual was merely a finder when he provided his contact list to the company and made introductions to potential investors. In making this finding, the SEC stressed the lack of any involvement in the negotiations of the transaction. Subsequent guidance has followed this initial finding. Therefore, to

avoid being deemed an unlicensed broker-dealer, a finder should do no more than make introductions.

• Regularity of facilitating investments

An individual that regularly acts as a finder is in danger of being deemed an unlicensed broker-dealer. The Paul Anka no-action letter also brought this factor to light. In finding that the individual was not an unlicensed broker-dealer, the SEC focused on the fact that the individual in question had not previously arranged investments and that he agreed not to be involved in arranging investments in the future. If the individual had been involved regularly in these types of transaction, the SEC might have reached a different result. Because of this, companies should be wary of individuals acting as regular finders.

• Compensation

The SEC gives great weight to transaction-based compensation when determining whether an individual is acting as an unlicensed broker-dealer. It has gone as far as stating that transaction-based compensation is a hallmark of being a broker-dealer. Although transaction-based compensation does not automatically revoke the finder exemption, it definitely increases the risk of being deemed an unlicensed broker-dealer. Companies must be very careful when paying fees to finders and should try to avoid paying fees based on the amount of capital an individual is responsible for bringing in to the company. One possible option for a company to consider is to pay an upfront fixed fee to the finder, but the SEC has not stated whether such an arrangement would be acceptable.

Consequences of using an unregistered broker-dealer

Using an unregistered broker-dealer will subject a company to regulatory and individual actions. Regulatory actions by the states and the SEC may include questioning the reliance on a private placement exemption, prohibiting the company from future Regulation D offerings, company aider and abettor liability, and the unenforceability of the agreement between the company and finder. Rescission rights and individual actions by investors may also arise under California Corporation Code Section 25501.5.

With the passage of Corporation Code Section 25510.5, a fund sponsor who has raised funds, an entity that has raised capital or a seller of a company could all be subject to a rescission right by a buyer if an intermediary is involved who is paid a fee and is not properly licensed in California. Due to its recent passage, very little guidance exists at this time concerning the parameters of the rescission

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right provided for in California Corporation Code Section 25501.5. Comments to the assembly bill state that the bill was designed to address the problem of bucket shops or boiler rooms that engage in securities fraud and to specifically target disreputable brokers who victimize consumers by operating illegally, such as unlicensed persons who sell mortgage pools, pyramid or Ponzi schemes, and persons licensed in a related field, like insurance, who sell securities to their existing clients without obtaining the proper securities licenses. Except in the case of these unusual securities, most finders do not own the securities they sell and are acting as an agent of the company.

Section 25501.5 provides two alternative remedies if a violation has occurred. First, if the purchaser still owns the security, the purchaser may bring an action for rescission and tender the security. If a rescission occurs, the statute provides that the purchaser may recover the consideration paid for security plus the legal rate of interest, less the amount of any income received on the investment.

Secondly, if the purchaser no longer owns the security, the purchaser may sue for damages. Damages recoverable are in an

amount equal to the difference between the price at which the security is bought plus the legal rate of interest reduced by the value of the security at the time it was disposed of by the purchaser plus any income previously received by the purchaser on the security.

In addition to the foregoing remedies, a court is empowered, in its discretion to award reimbursement of reasonable attorney fees to a prevailing plaintiff under this section.

Conclusion

As a matter of course in connection with any sale of a business or fund raising in which an intermediary is involved who is to receive compensation, an analysis must be made whether such individual is truly a finder or, if not, whether such person is properly licensed. If such intermediary is not properly licensed in California risk exists under Corporation Code Section 25501.5 that a rescission right will exist or that a damage claim may exist if the security in question has been sold.

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