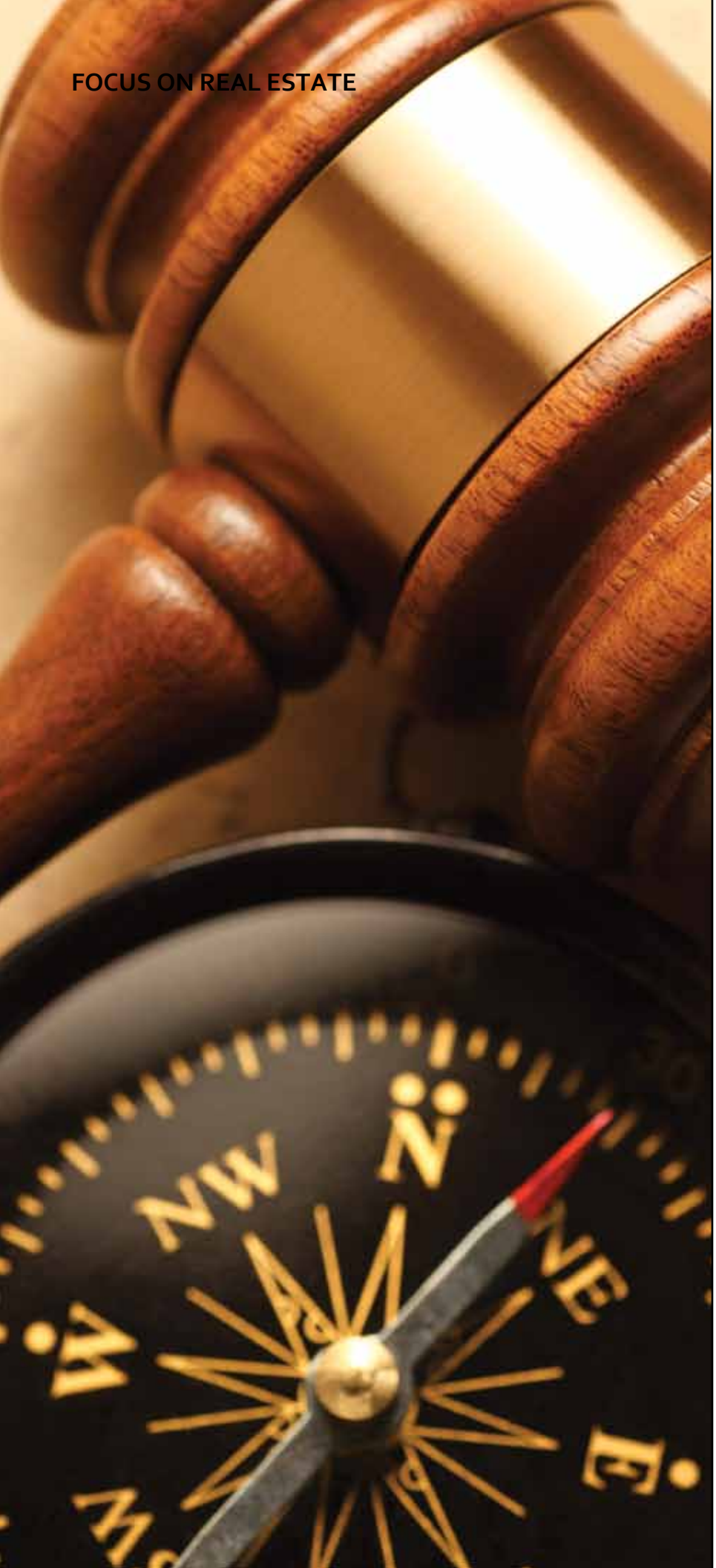

PROTECT YOUR SUCCESS FEES!

REAL ESTATE LICENSING considerations *for* EMDs

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Introduction

In the recent editions of Exempt Market Update, in the articles *Engagement Letter Best Practices – Part One* and *Part Two*, we focused on two topical features of an EMD's engagement letter: exclusivity and fee-tails. In this edition we consider an often overlooked, but critical aspect of the regulatory environment in which EMDs operate – the broker licensing requirement under the *Real Estate and* ***Business Brokers*** *Act* (Ontario)(**REBBA** or the **Act**). This requirement can certainly have an impact on drafting an engagement letter, as well as much wider implications for the offering of M&A advisory services in the province of Ontario.

Business Landscape

EMD's often engage in a dual business model of raising funding for issuers (whether involved in the real property sector or otherwise) and providing M&A advisory services to purchasers of businesses and potential acquisition targets. Alternatively, a sub-set of firms have adopted a single-focus service model of providing advice only in respect of the purchase and sale of businesses – these firms, provided they do not engage in capital-raising activities, are largely not required to register as EMDs under securities laws. A little more on that later.

Regardless of your service model, given the exceedingly broad drafting of certain operative definitions in REBBA, both EMDs engaged to raise capital for issuers operating in the real property sector (for ease we'll call these '**capital-raisers**'), and those offering advisory services to clients in the M&A context **in any sector** (we'll call these '**M&A advisors**', along with their non-EMD-registered competitors), in either case without the benefit of a REBBA brokerage license, should be cognizant of their regulatory and financial exposure under the Act.

The question is: what are the risks, and what can be done about them?

M&A Advisor as Real Estate Broker – Legislation and Consequences

Few M&A advisors presently take concrete steps to mitigate the risk that the services they provide or have provided could be deemed to require registration under REBBA. In a way, that's understandable (to the extent that any thought at all is given to the application of REBBA) especially so in the context of providing M&A advisory services, where the typical response is "*Oh, that Act governs real estate agents and brokerages and my firm isn't operating as a real estate brokerage. Why are you bothering me? End of story.*"

Nothing could be further from the truth. REBBA's purpose is to regulate individuals and firms that 'trade' in 'real estate,' whether directly or indirectly. The difficulty arises from how these terms are defined in the Act, as well as the title of the Act itself. The title of the Act clearly evidences an intention to regulate "*Business Brokers*", and "*Real Estate*" is intentionally defined to include a 'business', whether with or without premises, and the goods connected with operating a business (**in any sector**). "*Business*", in turn, means an undertaking carried on for gain or profit or **any interest in** such undertaking. "*Trade*" (not unlike the all-encompassing definition in the *Securities Act*) includes a disposition, acquisition or transaction in "*real estate*", and any act, advertisement, conduct or **negotiation** directly or indirectly in furtherance of any such transaction.

REBBA's starting point (subject to the crucial exemptions discussed below) is that engaging in a 'trade in real estate' requires registration under the Act. So on a plain reading of the Act, at a minimum, capital-raisers arranging equity or convertible financing for real property issuers (such equity, particularly partnership interests, being considered an 'interest in' real estate), or an M&A advisory firm assisting clients in any sector would need to be registered as brokerages in order to offer the services typically contemplated by a standard Term Sheet or M&A engagement letter.

The registration requirement has two important potential consequences. First, there exists the "nuclear bomb" contained in Section 9 of the Act, that a non-REBBA licensed M&A advisor is legally barred from bringing an action to enforce a client's contractual obligation to pay fees or commissions where a transaction involved a 'trade in real estate' – the practical effect of which is that a non-REBBA licensed M&A advisor may have no recourse in the event a client chooses not to honour that obligation in such circumstances (what we refer to as "we'd love to pay you but, but simply aren't permitted to," i.e. an advisor's '**financial risk**'). Second, the Real Estate Council of Ontario (**RECO**) is authorized to institute a criminal proceeding and impose fines for non-compliance with the Act, and may also apply for a court order restraining a non-REBBA licensed M&A advisor's conduct in relation to perceived non-compliance (what we refer to as an advisor's '**regulatory risk**').

Registered brokerages under REBBA are subject to a comprehensive conduct and compliance regime similar in nature (though not as to specifics) to that applicable to firms registered under securities laws. Given the attendant compliance burden, registration under REBBA is likely to be a suboptimal solution for the vast majority of capital-raisers and M&A advisors. So, we must consider: the key factors affecting the risks of being unlicensed, the critical statutory exemptions to REBBA available to capital-raisers and M&A advisors (which in our view give a leg-up to EMD's over their non-EMD-registered competitors), and most importantly, the positive steps and measures capital-raisers and M&A advisors might take in an effort to mitigate their regulatory and financial risk.

Practical Aspects of Regulatory Risk

The fact is, the most serious consequences described above are relatively unlikely to occur in respect of a capital-raiser or M&A advisor's operations. For instance, there have been no reported instances of a capital-raiser or M&A advisor being charged with an offence under REBBA. However, we have had very recent first-hand experience with RECO making unsolicited inquiries and requesting a detailed accounting of the activities of non-EMD-registered M&A advisors for the apparent purpose of determining whether their registration under the Act is required. Most recently, a beneficial resolution was reached with RECO that permitted the advisor to continue operations without a REBBA registration or other regulatory obligations under the Act, largely on the basis of the reasoning summarized below. It is noteworthy that RECO does not wield the same broad investigative powers as the Ontario Securities Commission in respect of compelling information and investigating alleged misconduct or unregistered trading activity. Nonetheless, to the extent RECO's recent inquiries into the activities of M&A advisors signify a trend of increased regulatory scrutiny of M&A advisory services, M&A advisors and financial advisors should sit up and take notice.

What about capital-raisers or M&A advisors located or advising on transactions outside Ontario? Though there are no hard and fast rules concerning the connection to Ontario in the context of a particular transaction sufficient to trigger the application of the Act, the general view is that if an capital-raiser, M&A advisor, client or target business is situated in Ontario, any of these features may attract the application of REBBA to the advisor's activities. However, the specific geographical orientation of the parties to a transaction is likely to significantly impact RECO's legal and practical ability to pursue a compliance action.

Practical Aspects of Financial Risk

What if a client refuses to pay the success fee it agreed to in the engagement letter following successful completion of a mandate on the basis that your firm is not licensed under REBBA? Given the lack of published regulatory enforcement proceedings under REBBA, the most useful guidance for gauging both the regulatory and financial risks arising from the Act's exceptionally broad drafting is in the context of Court proceedings instituted by M&A advisors against former clients for unpaid success fees.

Fortunately, in the context of success fee collection cases, Courts have tended to interpret REBBA in a restrictive manner, preferring the plain and ordinary meanings of the controversially defined terms, and have read the Act in such a way as to avoid the unfairness that would result from preventing an advisor from collecting success fees they have otherwise fairly earned.

We can infer two key points from these success fee collection Court decisions, namely that **without** requiring registration under the Act:

- an M&A advisor may generally render services in relation to the sale of a business effected as an acquisition of previously issued shares; and
- a single transaction may be divided into separate parts and the aspects relating to 'real property' or 'leasehold' carved out and treated as exclusive of the underlying transaction on which the M&A advisor is providing services.

There is additional practical guidance to be derived from these principles which may indicate ways in which M&A advisors can mitigate their regulatory and financial risk, as discussed further below.

Two problematic aspects of the available decisions should be noted. As there are relatively few reported Court decisions (though there are no doubt many more instances where the matter was settled out of Court), and the cases arise in the context of actions for success fees and often turn on their particular facts, it is difficult to make reliable generalizations to other contexts or circumstances. Additionally, the M&A advisor is rarely awarded any commissions in respect of the 'parts' of the transaction relating to real property or leasehold, despite that such success fees are often negotiated with the client in the engagement agreement through the application of enterprise value or Lehman Scale success based fee formulas.

Statutory Exemptions for Capital-Raisers and M&A Advisors

The Act sets out a number of exemptions from the requirement to be registered as a REBBA broker in respect of certain trades in real estate, certain of which exemptions are critically useful to EMDs engaging in capital raising for real property issuers and for EMDs providing M&A advisory services in relation to the sale of business in any sector: (a) in minimizing the risk their services could be deemed to require such registration; and (b) which give registered EMDs a competitive advantage over their non-EMD-registered M&A advisor competitors.

These exemptions are available for use without the requirement to make any filings or notifications.

1. For our purposes, perhaps the most relevant exemption in Section 5(c) of the Act, which is available to a person registered under the *Securities Act* (Ontario), if the trade in real estate in question is made in the course of the person's business *in connection with a trade in securities.*

One hugely evident benefit of the EMD registration in Ontario is the availability of this exemption to EMDs. An EMD can raise funding for issuers in the real property sector or otherwise, and can, to the extent its business model encompasses it, advise on the sale of previously issued securities (whether shares, convertible securities, limited partnership interests, trust units or otherwise) in any sector in connection with the sale of a business and collect their success fees in full (i.e. without the financial risk of having a Court invalidate that portion of the success fee associated with the real property or leasing portion of the transaction) without worry.

While it is not definitive whether the exemption under the Act is broader (we think it most certainly is) than the common law carve-out discussed above with respect to transactions effected entirely by way of a purchase and sale of shares of a business, or simply a codification thereof, it could be argued that it is reasonable for an EMD to avail itself of the exemption in respect of certain transactions structured primarily as a sale of assets but which also involve a trade in securities or which are initially offered in the Confidential Information Memorandum as either a sale or shares or assets, though the transaction ultimately closes as a sale of assets, on the two-pronged basis: (a) of taking a broad interpretation of the Section 5(c) wording "in connection" with a trade in securities; and (b) given that EMDs have voluntarily submitted to the jurisdiction and oversight of the Securities Commissions and the comprehensive regulatory regime of securities legislation, it makes little theoretical sense that EMD's would be permitted to advise on sales of businesses structured as sales of securities (of any kind), but not those structured as sales of assets, given the purpose and end result of either structure are the same.

It is in this context that the somewhat paradoxical approaches of Canadian regulators to a 'trade in securities' vs. a 'trade in real estate' is apparent. The absurdity of 'form over substance' in regulating a sale transaction is one area, at least, that securities regulators tend to get right. For them, there is no meaningful difference whether the sale of a business is effected as a sale of shares or assets – a 'trade in securities' effected in connection with the sale of a business is purely 'incidental to the acquisition transaction'. In this respect, it appears securities regulators have recognized the importance of 'substance over form' in determining the scope of regulation. It is curious that a similarly pragmatic approach has not explicitly been developed in the context of REBBA.

It may also be possible for an EMD to take the position that the sale of a business as a going concern, which is structured purely as a sale of assets, could in certain circumstances constitute a trade in an 'investment contract' within the meaning of 'security' under applicable securities laws, bringing such an asset sale transaction squarely within the ambit of the Section 5(c) exemption.

2. There is also an exemption available to lawyers licensed in Ontario if the trade in real estate is a legal service or is incidental to and directly arises out of a legal service. In this regard, an M&A advisor may, with a view to protecting the enforceability of its success fee, wish to assign to its or its client's legal counsel the sole responsibility and oversight of any aspects of a proposed transaction involving real property or leasehold (in keeping with the 'bifurcated transaction approach developed by the Courts). Put accurately, but inelegantly, to the M&A advisor: "Don't touch real property!" – whether land, leases or otherwise, and in the context of M&A transactions there is virtually always some real property interest involved, whether the physical plant, the land the plant sits on, or the lease.

The use of exemptions 1 or 2 in conjunction with the additional practical measures suggested below is likely to further reduce an M&A advisor's risk exposure.

3. There is an exemption available "in respect of any mine or mining property within the meaning of the *Mining Act* or… mining claim

or mineral lands under the *Mining Act* or any predecessor of that Act". While this exemption may offer comfort for M&A advisors acting in the mining and mineral exploration context, it would be advisable to consult with legal counsel regarding the drafting and scope of this exemption prior to its use.

Mitigating Risk – Practical Measures

In light of the state of the law concerning REBBA's application to M&A advisory activities, the additional suggestions listed below may serve as useful points of discussion for M&A advisors and their legal counsel in considering best practices and how to practically manage risk in relation to each transaction or mandate; however, there is no guarantee that any one or more of the suggestions below will be effective in so doing. Certain of these points may also be impracticable or undesirable in the context of the business model, services or clientele of a particular M&A advisor or in the specific circumstances of a transaction and will need to be assessed and adapted to the individualized needs of each M&A advisor.

Drafting the Engagement Letter

- *Characterization of Success Fees* – Inclusion of mutual acknowledgments, ideally backed by supporting information respecting attribution of value, that (i) the fees and commissions payable under the engagement are in respect of the non-real property and leasehold assets only (the **Included Assets**), such commission being fairly and accurately calculated in relation to only the Included Assets, (ii) the real property and leasehold interests of the target (the **Excluded Assets**) are purely incidental and inconsequential to the overall transaction, the Included Assets being the core assets and drivers of value of the target business, and (iii) as a result, the Excluded Assets have little or no ascertainable value independent from the Included Assets.
- *Severability Provision* – To the extent that a court or arbitrator does not agree with the parties' characterization of the success fee despite statements to the contrary, or such statements are not included, a provision could be included to address it. The effect would be that, where Included Assets and Excluded Assets are being sold together in the context of a larger transaction, the engagement agreement will be severable such that the M&A advisor may collect all applicable fees and commissions attributable to non-Excluded Assets. It may then fall to a Court to determine this attribution, but at least the M&A advisor is less likely to go away empty-handed.
- *Scope of Services* – In negotiating the scope of services, ensure the agreement is explicit that the advisor will not provide services of any kind in relation to Excluded Assets (valuation, negotiation, packaging or preparation for sale, drafting or providing descriptions or explanations of such assets, etc.). May also provide that a registered broker under REBBA (i.e. a real estate brokerage or agent) or qualified legal counsel will advise in respect of the Excluded Assets. This is a scaled-back approach to a bifurcated transaction structure discussed below.

Disclaimers and Exculpatory Statements

The points above regarding characterization of commissions and severability are geared more towards addressing financial risk. Disclaimers may prove useful in managing both regulatory and financial risk.

- *Language* – Explicit language to the effect that the M&A Advisor is not being engaged to, and will not in the course of its mandate, advise or provide services in relation to any real property or leasehold interests of the target, or otherwise act in a manner requiring registration under REBBA, and that that nothing contained in the document is intended to be or shall be deemed a solicitation for the purchase or lease of real property, which activities may only be conducted in accordance with REBBA.
- *Inclusion in Documents* – Such exculpatory language pertaining to the M&A advisor could also be included in any Confidential Information Memorandum or Pitch Book, slide deck and other documents or materials provided to prospective purchaser of a business, investors or other participating parties in relation to the transaction. Similarly, if the scope of the M&A advisor's mandate has been contractually restricted, there is likely a benefit to highlighting this fact in such documents.
- *Contractual Provisions* – In connection with inclusion of such language in the various documents, it would also be advisable to obtain a representation and acknowledgement to the same effect from the client in the engagement agreement.

Transaction Structuring (assuming a sale of shares is not contemplated by the parties)

- *Bifurcating Transactions* or '*Split Engagement*' – If practicable and warranted by the circumstances, the purchase and sale transaction may be structured as two distinct transactions, carving out Excluded Assets. Prepare documentation necessary to reflect the restriction on the M&A advisor's mandate. Engage a REBBA-registered broker or arrange for qualified legal counsel to advise in respect of the Excluded Asset transaction. While more costly to implement, a bifurcated structure would be particularly germane in the context where a target company holds significant real property assets.

Navigating the REBBA, as it pertains to EMDs offering M&A advisory services and even their non-EMD-registered competitors, requires careful consideration from the earliest stages of a transaction, in terms of drafting the Engagement Letter, preparing the Confidential Information Memorandum or Pitch Book, determining the underlying asset vs. share structure and negotiating definitive documentation. The writers are available to assist in implementing customized, practical techniques, strategies and solutions which will avoid traps for the unwary, not least of which is an assurance that your success fee will be fully collectable upon completion of the transaction.

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