When Investment Banks Can Sell Real Estate In Calif.

By **Christopher Froelich, Douglas Praw and Chris Gregores** (July 28, 2023)

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In merger and acquisition transactions in which whole businesses or companies are traded, and the real estate is only a component of the overall deal, it is not uncommon for an investment bank to be involved.

Given the real estate slowdown during the last few months, much of the actual real estate activity that we've seen has been through M&A and private equity transactions. Deal participants should be mindful of California law as they engage in deals that include some amount of real estate.

In California, it is unlawful for a person to act as a real estate broker — i.e., to sell real estate — without having a real estate license. A party in violation of this licensing requirement is barred from suing for compensation for services rendered.[1]

Most investment banks are licensed securities broker-dealers, but are not licensed real estate brokers. Thus, depending on the circumstances, an investment bank that sells a business that owns real property in California could find itself in the unfortunate position of not being able to collect its investment banking fee from its client, the seller, following the closing of a transaction.

This article examines whether an investment bank is required to carry a real estate license in California in order to sell a business that owns real estate in California.

The general rule in California, codified in California Business and Professions Code Section 10131, is that parties facilitating a transaction, i.e., brokers, with a real property component are required to hold a real estate brokerage license.

Specifically, this rule requires that a party negotiating the sale or purchase of a certain business opportunity, where real estate is a component of that business opportunity, hold a real estate license.

The code provides that a real estate broker is a person who sells, solicits prospective buyers or sellers, or negotiates the purchase, sale or exchange of real property or a business opportunity.[2] A "business opportunity" is defined to include the sale or lease of the business and goodwill of an existing business enterprise.[3]

From 1965 until September 1989, one who negotiated the sale of a business opportunity fell within the definition of a real estate broker and was required to obtain a real estate brokerage license to facilitate such transactions.[4] However, certain case law and statutory changes modified that conclusion.

All Points Traders Inc. v. Barrington Associates

In All Points Traders Inc. v. Barrington Associates in 1989, the Court of Appeal of the State of California, Second Appellate District, Division Three, interpreted Code Section 10131.

The court found that, in a transaction involving the disposition of a corporation via a sale of its shares, the investment banking firm handling the sale should have obtained a real estate brokerage license, and was prohibited from collecting a commission as a result of the failure to do so.

The sale included a transfer of all the corporation's common stock, and, notably, a lease with an option to purchase the land upon which the business was located.

The court held that the sale of all the corporation's assets was in substance the sale of a business opportunity and that the investment firm was required to hold a real estate brokerage license, regardless of the fact that the transaction fell within the scope of securities regulations.[5]

Code Section 10008.5

The impact of the All Points Traders decision was short-lived, however, and does not reflect the current state of California's real estate brokerage licensing requirements.

In response to All Points Traders, California's Legislature enacted Code Section 10008.5, which provides that any transaction involving a business opportunity does not necessitate that a licensed securities broker obtain a real estate brokerage license, unless the substance of the transaction is to transfer, sell, lease or exchange an interest in real property. This leaves open the question: "What is the substance of the transaction?"

In a letter discussing legislative intent, two members of the California Legislature explained that the purpose of Code Section 10008.5 was to ensure that licensed securities broker-dealers, who customarily engage in large M&A transactions involving business opportunities, are not also required to obtain an additional license as a real estate broker.[6]

Recall that under Code Section 10131, any negotiation involving a business opportunity required the engagement of a licensed real estate broker, irrespective of whether the transaction contained a real estate component.

Case law after the adoption of Code Section 10008.5 resolved the ambiguity that surrounded the duplicative licensing requirement and also made clear that the failure to secure a real estate broker's license does not, in and of itself, preclude the recovery of commission earned in the sale of a business opportunity.

Shaw v. Jacobs

In Shaw v. Jacobs, in the California Court of Appeal in 2001, plaintiff William Shaw brought suit against certain defendants, Oxford Mergers and Acquisitions Inc., for breach of contract to recover a broker's commission generated by the sale of a business.

Shaw, as the holder of a securities dealer license, and Oxford, as the holder of a corporate real estate license, needed each other to complete certain transactions.

In July 1995, Shaw located a client, Standard Pacific Industries Inc., for the sale of 100% of its corporate stock, the sale of which notably did not include a real property component.

Shaw then identified a purchaser, KR Capital, and SPI sold 100% of its corporate stock to KRC in March 1997. Following the sale, Oxford insisted it was entitled to substantially all the commissions generated by the transaction.

Whereas Shaw argued he brokered the entire deal, Oxford took the position that it engaged Shaw to act as its agent pursuant to an agreement under which Shaw would be required to obtain a real estate license before commencing any work for which he would receive a commission. Shaw began the process but ultimately failed to obtain a real estate license.

Based on the All Points Traders case, the lower trial court concluded that Shaw's failure to secure a real estate broker's license precluded any action to recover a commission earned in the sale of a business opportunity.

Applying the Code Section 10008.5 exception, the Court of Appeals overturned the trial court's finding and determined that Shaw's lack of a real estate broker's license did not infringe upon his ability to recover a commission for the transaction. In relevant part, the court provided further insight as to the legislative intent of the Code Section 10008.5 exception when reaching its conclusion:

> Oxford argues the Legislature "likely" did not intend for the statutory exemption to apply to series 63 licensees, like Shaw, and he does not qualify as a "securities broker-dealer." Nothing in the statute supports the notion that only certain licensed securities brokers are exempt from the duplicate licensing requirements announced in All Points Traders.[7]

Takeaways

Ultimately, the requirement for a real estate license does not apply to a licensed securities broker or to any agent while acting under the direction of, and within the scope of employment of, said broker in connection with any transaction for the sale, lease or exchange of a business opportunity, unless the substance of the transaction pertains to an interest in real property for the purpose of evading the real estate license law.[8]

There is no clear legal standard for determining whether the sale of a business opportunity, at its essence, will be considered a real estate transaction for purposes of evading California real estate licensing law. The question for an investment bank selling a business that owns real estate in California: Is the real estate material or merely incidental to the deal at hand?

In answering this question, investment banks must take an objective look at the driving forces behind any given deal to determine whether the substance of the deal is the sale, lease or exchange of real property. If so, Code Section 10131 requires a real estate license. If not, a securities license is sufficient.

In some transactions, this determination may be difficult. In larger M&A transactions, however, where entire businesses are sold, and few real estate holdings follow, there is a strong case to be made that the real estate component is incidental.

To avoid potentially running afoul of licensing requirements where the materiality of the real estate component is uncertain, the safest bet is to engage a licensed California real estate broker. Alternatively, the real estate component could be unbundled from the portion of the deal within the scope of the securities licensing and sold separately.

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[1] California Business and Professions Code §§ 10130 and 10136.

[2] Code § 10131, subd. (a).

[3] Code § 10131, subd. (a).

[4] Code § 10131.

[5] All Points Traders, Inc. v. Barrington Associates, 211 Cal.App.3d 723, 259 Cal.Rptr. 780 (1989).

[6] Historical and Statutory Notes, 4A West's Ann. Bus. & Prof. Code (2001 supp.) foll. § 10008.5, p. 2.

[7] Shaw v. Jacobs, No. G025445, 2001 WL 1260838 (Cal. Ct. App. Oct. 19, 2001).

[8] Code § 10008.5.