Rule 3(a)(10) Fairness Hearings: An Overview

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As a general rule, all issuances of securities must either be (i) registered, or (ii) exempt from registration. When issuing securities for cash, issuers have a variety of exemptions to rely on, with the most common being Rule 506 of Regulation D. Because of the pre-emption provided by the National Securities Markets Improvements Act, issuers relying on Rule 506 have a state-level exemption to rely on as well.

However, in a merger or acquisition, finding an exemption is not such an easy task. In a typical merger or acquisition structure, the shareholders of the Target company will seek to exchange their stock in the Target company for stock in the Acquiring company. Like all securities issuances, the issuance of stock in the Acquiring company must either be registered or exempt from registration. But unlike securities issuances for cash, the shareholders of the Target company in a merger or acquisition are often numerous, from many different states or jurisdictions, and represent a wide range of investor qualifications (accredited, sophisticated, etc.). Often, the only solution given to the two companies by their securities counsel is registration.

Registration in a merger or acquisition is typically done on a Form S-4. An S-4 registration statement can be an intimidating document because it must contain full disclosure not only about the company issuing its securities (the Acquiring company), but also full disclosure about the company being acquired (the Target company), and then, if the Acquiring company is going to be materially different after the merger or acquisition, it must contain full disclosure about the post-merger entity. In some cases, this might be the equivalent disclosure of three S-1 registration statements. In addition, for companies designated as Smaller Reporting Companies by the SEC, who are not “S-3 eligible,” there can be no incorporation by reference. The disclosure must be provided in full.

Section 3(a)(10) Exemption

Section 3(a)(10) of the Securities Act of 1933 is an exemption from Securities Act registration for offers and sales of securities in specified exchange transactions, such as the merger or acquisition outlined above. Before the issuer can rely on the exemption, the following conditions must be met.

- The securities must be issued in exchange for securities, claims, or property interests; they cannot be offered for cash.

- A court or authorized governmental entity must approve the fairness of the terms and conditions of the exchange.

- The reviewing court or authorized governmental entity must:

  - find, before approving the transaction, that the terms and conditions of the exchange are fair to those to whom securities will be issued, and

  - be advised before the hearing that the issuer will rely on the Section 3(a)(10) exemption based on the court's or authorized governmental entity's approval of the transaction.

- The court or authorized governmental entity must hold a hearing before approving the fairness of the terms and conditions of the transaction.

- A governmental entity must be expressly authorized by law to hold the hearing, although it is not necessary that the law require the hearing.

- The fairness hearing must be open to everyone to whom securities would be issued in the proposed exchange.

- Adequate notice must be given to all those persons.

- There cannot be any improper impediments to the appearance by those persons at the hearing.

The Securities and Exchange Commission issued a Staff Legal Bulletin in June 2008 regarding Section 3(a)(10). The Staff Legal Bulletin can be read here.

There are only six states in the United States that have a formal process for 3(a)(10) hearings. Coincidentally, two of those states are California and Utah, both of which are states where lawyers from The Lebrecht Group, APLC practice.

California's Corporations Code Section 25142 allows companies to apply for a fairness hearing. The process has been used extensively by California's high tech industry, particularly in economic times when mergers and acquisitions were plentiful. The California Department of Corporations provides a list of companies that conducted hearings between 2001 and 2006. The statistics show that there was a high of 101 hearings in 2000-2001, down to a low of 10 in 2008. What's more, all of the filings made by companies in connection with these hearings are publicly available and can be obtained at the Department of Corporations offices.

By contrast, Utah Code Annotated Section 61-1-11.1 allows companies to apply for a fairness hearing. The last time I talked with the Utah Securities Division, they had conducted one such hearing since the statutes enactment in 2003. Utah's application process is outlined here.

Standard of Review and Jurisdiction

In all fairness hearings, the determination to be made by the governmental agency is whether the securities (together with any other consideration) being issued in the transaction are "fair." If the answer is yes, then the securities can be issued without registration, and there will be no restrictions on the resale of those securities (except those imposed on affiliates of the issuer).

In January 2006, in response to the SEC's new positions on shell companies, the California Department of Corporations issued Corporations Commission Release No. 117-C, stating that the fairness hearing process would not be available for mergers involving shell companies.

Under the Utah statute, the applicant must be (i) a Utah entity, (ii) a foreign entity domiciled in Utah, or (iii) at least 30% of the Target company shareholders to receive securities in the transaction must be domiciled in Utah.

California has been known to hold a hearing when as few as one shareholder is a California resident.

Timing and Cost

The cost to do an S-4 registration statement is in the neighborhood of $100,000 by the time you draft the document and respond to SEC comments until effectiveness. The timing can be between 3 and 6 months.

Depending on the number of fairness hearings pending at any given time, the timing might be as little as 1 month, and the cost is less than half that of an S-4 registration statement.

Conclusion

A Rule 3(a)(10) Fairness Hearing may be a viable alternative for companies undergoing a merger or acquisition, particularly if the shareholders of the Target company are numerous, from many different states or jurisdictions, and/or represent a wide range of investor qualifications. At the very least the process should be considered in these situations based on time and cost factors alone. You should contact a qualified attorney if your company is considering undergoing a merger or acquisition to answer any questions regarding Rule 3(a)(10) fairness hearings.

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The Lebrecht Group, APLC provides comprehensive advice on a variety of corporate and securities law matters. Please contact us if you have any questions.

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