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COMMENTS

FAIRNESS REQUIREMENT IN SECTION 3(a)(10) OF THE SECURITIES ACT OF 1933

Section 3(a)(10) of the Securities Act of 1933 (1933 Act)¹ provides an exemption from the registration requirements of section 5 of the Act² when securities are issued in certain exchanges and an authorized body has approved the fairness of the terms and conditions of the exchange.³ The essence of the exemption is the examination and approval by a court or other authorized body of the fairness of the exchange.⁴ Thus, the substantive requirements of "fairness" determine the extent of judicial involvement required by section 3(a)(10).

Few cases have addressed the general requirements of section 3(a)(10),⁵ and, in particular, no court has formulated an explicit definition of fairness.⁶ In *SEC v. Blinder Robinson & Co.*,⁷ however, the United States District Court for the District of Colorado

1. Securities Act of 1933, § 3(a)(10), 15 U.S.C. § 77c(a)(10) (Supp. IV 1980).

2. *Id.* § 5, 15 U.S.C. § 77e (1976). Exempted securities and transactions still may be subject to the antifraud provisions of the Act. *Id.* §§ 12, 17, 15 U.S.C. §§ 77l, 77q. See generally 1 L. LOSS, *SECURITIES REGULATION* 179, 1423-30 (2d ed. 1961).

3. See Securities Act of 1933, § 3(a)(10), 15 U.S.C. § 77c(a)(10) (Supp. IV 1980). For the complete text of § 3(a)(10), see text accompanying note 27 *infra*.

4. See note 3 & accompanying text *supra*; SEC Securities Act Release No. 312 (Mar. 15, 1935) [hereinafter cited as SEC Release No. 312], reprinted in 1 *FED. SEC. L. REP. (CCH)* ¶¶ 2181-2184. If the court or authorized body concludes that an exchange is fair, it will approve the exchange. For ease of discussion this Comment will refer to all approval bodies as "the court."

5. A recent commentator could find only one case, *Merger Mines Corp. v. Grismer*, 137 F.2d 335 (9th Cir.), cert. denied, 320 U.S. 794 (1943), that interpreted § 3(a)(10). Ash, *Reorganizations and Other Exchanges Under Section 3(a)(10) of the Securities Act of 1933*, 75 *Nw. U.L. REV.* 1, 6 (1980).

6. Ash, *supra* note 5, at 17; Comment, *Issuance of Securities in Reorganizations and Arrangements under the Bankruptcy Act and the Proposed Bankruptcy Act*, 36 *OHIO ST. L.J.* 380, 398 (1975).

7. 511 F. Supp. 799 (D. Colo. 1981).

enumerated specific factors to guide the court's determination of fairness in a section 3(a)(10) proceeding.⁸ The court ordered final approval of a settlement in which unregistered securities were to be issued in exchange for outstanding claims against the issuing corporation and concluded that its consideration of fairness complied with the purpose of the 1933 Act.⁹

This Comment will examine the fairness criteria set forth in *Blinder Robinson* and the role of the court in approving section 3(a)(10) exchanges. This Comment concludes that the fairness requirement of section 3(a)(10) imposes a duty on the court to scrutinize the terms and conditions of the proposed exchange and that in formulating its fairness criteria the court in *Blinder Robinson* misinterpreted section 3(a)(10). In practice, the decision in *Blinder Robinson* encourages the issuance of unregistered securities without adequate investor protection and thereby demonstrates the necessity of remedial action by the Securities and Exchange Commission (SEC).

LEGISLATIVE HISTORY OF SECTION 3(a)(10)

In response to the collapse of the financial markets in the late 1920's and early 1930's,¹⁰ Congress passed, at the President's urging,¹¹ the Securities Act of 1933.¹² Primarily based on a theory of full disclosure,¹³ the 1933 Act sought to protect investors and the public from misrepresentations in the sale and issuance of securities.¹⁴ To aid the public in making informed investment decisions, section 5 of the 1933 Act requires issuers to file a registration statement with the SEC and deliver a prospectus to all potential investors.¹⁵ In limited circumstances, the 1933 Act provides exemp-

8. *Id.* at 801.

9. *Id.* at 802.

10. See generally 3 SEC. & FED. CORP. L. REP. (H. BLOOMENTHAL) § 1.01[1] [hereinafter cited as H. BLOOMENTHAL] (1981); 1 L. LOSS, *supra* note 2, at 119-21.

11. H.R. REP. NO. 85, 73d Cong., 1st Sess. 1-2 (1933) [hereinafter cited as H.R. REP. NO. 85].

12. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1976 & Supp. IV 1980)).

13. H.R. REP. NO. 85, *supra* note 11, at 3; see, e.g., *Sante Fe Indus. Inc. v. Green*, 430 U.S. 462 (1977); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

14. H.R. REP. NO. 85, *supra* note 11, at 2-3.

15. Securities Act of 1933, § 5, 15 U.S.C. § 77e (1976).

tions from these registration requirements.¹⁶ Specifically, section 3(a)(10) of the 1933 Act exempts from section 5 requirements securities issued in exchange for other securities, claims, or property interests when an authorized body approves the fairness of the exchange.¹⁷

As originally enacted, the 1933 Act did not include the present section 3(a)(10); rather, section 3(a)(10) was part of a broader exemption found in section 4(3).¹⁸ The purpose of section 4(3) was to exempt from registration requirements securities issued in judicially supervised reorganizations of financially troubled corporations.¹⁹ As contemplated by the 1933 Act, the role of the court was crucial to the availability of the section 4(3) exemption. Specifically, Congress noted that "[r]eorganizations carried out without such judicial supervision possess all the dangers implicit in the issuance of new securities and are, therefore, not exempt from the act. For the same reason the provision is not broad enough to include mergers or consolidations of corporations entered into without judicial supervision."²⁰ Although the legislative history of section 4(3) exemptions clearly required court involvement, the extent of that judicial role was unclear.

Congress enacted section 3(a)(10) as an amendment to the 1933 Act. The amendment, which moved the exemption from section 4 to section 3 of the 1933 Act and broadened its applicability, was part of the Securities Exchange Act of 1934 (1934 Act).²¹ The Conference Report explained that the new section 3(a)(10) extended the provisions of section 4(3) to include various exchanges as well as reorganizations.²² Additionally, the Conference Report stated:

16. Section 3 of the 1933 Act exempts certain types of securities from the registration requirements. Securities Act of 1933, § 3, 15 U.S.C. § 77c (1976 & Supp. IV 1980). In contrast § 4 exempts certain transactions, such as private placements. *Id.* § 4, 15 U.S.C. § 77d.

17. See note 3 & accompanying text *supra*.

18. Securities Act of 1933, § 4(3), ch. 38, 38 Stat. 77.

19. H.R. REP. NO. 85, *supra* note 11, at 16.

20. *Id.*

21. Securities Exchange Act of 1934, ch. 404, § 202(c), 48 Stat. 906 (amending Securities Act of 1933, § 4(3)) (currently codified at 15 U.S.C. § 77c(a)(10) (Supp. IV 1980)).

22. H.R. REP. NO. 1838, 73d Cong., 2d Sess. 40 (1934). The Conference Report stated that § 3(a)(10) was intended "to cover readjustments of rights of holders of securities, claims and property interests, under court or similar supervision, even though the original issuer of the securities, debtor on the claims, or owner of the property in which interests are held, is not itself in the process of reorganization." *Id.*

A limitation on the exemption has been added by the conferees in the requirement that the approval of the court or official, in order to be effective, must follow a hearing on the fairness of the terms and conditions of the issuance and exchange of the securities at which persons who are to receive such securities shall have a right to appear.²³

The 1934 amendments thus clarified the otherwise vague section 4(3) requirement of judicial supervision²⁴ by adding that section 3(a)(10) required the court to determine the fairness of the proposed exchange. As a result, the extent of judicial involvement required in approving a section 3(a)(10) exchange theoretically was linked to the type of fairness inquiry required by section 3(a)(10). In a landmark release regarding section 3(a)(10) the SEC explained:

[T]he whole justification for the exemption afforded by section 3(a)(10) is that examination and approval by the body in question of the fairness of the issue in question is a substitute for the protection afforded to the investor by the information which would otherwise be made available to him through registration.²⁵

Since its enactment and subsequent clarification by Congress and the SEC, however, section 3(a)(10) has aroused little interest among practitioners or commentators because of uncertainty regarding standards for the fairness inquiry and the availability of other exemptions.²⁶

23. *Id.*

24. See note 19 & accompanying text *supra*.

25. SEC Release No. 312, *supra* note 4, at —, 1 FED. SEC. L. REP. ¶ 2183.

26. See, e.g., Ash, *supra* note 5, at 6-7; Mann, *The Section 3(a)(10) Exemption: Recent Interpretations*, 22 U.C.L.A. L. REV. 1247 (1975); Rapp, *The Interface Between Securities Act § 3(a)(10) and Ohio Revised Code § 1707.04: Utilitarian Considerations for Ohio Mergers and Corporate Reorganizations Transactions*, 27 CLEV. ST. L. REV. 1, 12 (1978). Apparently many securities lawyers in New York City are unfamiliar with § 3(a)(10). 1 H. MARSH & R. VOLK, *PRACTICE UNDER THE CALIFORNIA SECURITIES LAW*, § 7.11[2] n.2 (1981).

Practitioners rely upon other exemptions in the 1933 Act for similar transactions. These exemptions primarily included §§ 3(a)(9), 3(a)(11), and 4(2), 15 U.S.C. §§ 77c(a)(9), 77c(a)(11), 77d(2) (1976 & Supp. IV 1980). See Ash, *supra* note 5, at 28-36. More importantly, practitioners relied on Rule 133 of the 1933 Act to avoid § 5 registration requirements. Rule 133 was widely available as an exemption in transactions similar to § 3(a)(10) transactions because it construed exchange transactions as not constituting a "sale," see 17 C.F.R. § 230.133 (1981), and only transactions that are "sales" are required to comply with § 5 of the 1933 Act, Securities Act of 1933, § 5, 15 U.S.C. § 77e (1976). Promulgation of Rule

CURRENT ADMINISTRATION OF THE SECTION 3(a)(10) EXEMPTION

Section 3(a)(10) of the 1933 Act specifically exempts from section 5 coverage

any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval.²⁷

The section 3(a)(10) exemption recently has been invoked to exempt securities in connection with mergers,²⁸ consolidations,²⁹ and settlements of litigation.³⁰ The repeal of the "no-sale" theory of Rule 133³¹ suggests that practitioners will rely increasingly on the section 3(a)(10) exemption; however, practically no law exists on section 3(a)(10).³² Only available SEC releases and no-action and interpretive letters provide guidelines for administration of a sec-

145, however, rescinded the "no-sale" theory of Rule 133, effective January 1, 1973. 17 C.F.R. § 230.145 (1981); SEC Securities Act Release No. 5316 (Oct. 6, 1972), *reprinted in* [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,015.

27. Securities Act of 1933, § 3(a)(10), 15 U.S.C. § 77c(a)(10) (Supp. IV 1980). Recently Congress amended § 3(a)(10) to exclude securities exchanged in a bankruptcy proceeding under title 11 of the United States Code. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 306(b), 92 Stat. 2674.

28. *See, e.g.*, Tidelands Capital Corp., SEC No-Action Letter (July 2, 1980), *reprinted in* [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,434; Entex, Inc., SEC No-Action Letter (Dec. 11, 1978).

29. *See, e.g.*, Statesman Group, Inc., SEC No-Action Letter (Oct. 22, 1980); Farmers Group, Inc., SEC No-Action Letter (Nov. 25, 1977).

30. *See, e.g.*, SEC v. Blinder Robinson & Co., 511 F. Supp. 799 (D. Colo. 1981); Builders Inv. Group, SEC No-Action Letter (Dec. 15, 1978); LIN Broadcasting Co., SEC No-Action Letter (Dec. 8, 1972), *reprinted in* [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,154.

31. *See* note 26 *supra*; Ash, *supra* note 5, at 31-32; Mann, *supra* note 26, at 1249; Rapp, *supra* note 26, at 5-7.

32. *See* note 5 & accompanying text *supra*.

tion 3(a)(10) exemption.³³

In determining whether to approve an exchange, the SEC and the courts have focused primarily on four requirements. First, courts may not approve an exchange involving section 3(a)(10) when a hearing on the fairness of the exchange has not been held. The only court that interpreted section 3(a)(10) held that, because no hearing had been held, the lower court erred in approving an issuance of unregistered stock.³⁴ More recently, the SEC staff refused to recommend a "no-action" position when a state authority proposed to approve an exchange without holding a fairness hearing.³⁵ Additionally, state statutes modeled after section 3(a)(10) of the 1933 Act provide statutory hearing requirements.³⁶

Second, all persons proposed to be issued securities must receive notice of the fairness hearing. The notice requirement is not explicit in the language of section 3(a)(10), but the SEC has determined that to give substance to the hearing requirement notice is essential.³⁷ At least one state that has modeled its state registration exemption on section 3(a)(10) provides a statutory notice requirement.³⁸ Furthermore, recent no-action letters confirm that notice is crucial to the proper application of the section 3(a)(10) exemption.³⁹

Third, the SEC has applied strictly the requirement that all per-

33. No-action and interpretive letters are opinions of the SEC's Corporate Finance Division concerning whether enforcement action should be recommended in a given fact situation. Although such letters are not statements of law, they are accorded considerable weight, especially in an area such as § 3(a)(10) for which no significant case law exists. *See generally* Mann, *supra* note 26, at 1249-50. This Comment will refer to all no-action and interpretive letters as "no-action letters" because no significant distinction between the two exists.

34. *Merger Mines Corp. v. Grismer*, 137 F.2d 335 (9th Cir.), *cert. denied*, 320 U.S. 794 (1943).

35. Citizens Valley Bank, SEC No-Action Letter (Aug. 20, 1973) (state authority examined fairness but did not give adequate notice and right to appear to stockholders).

36. *See, e.g.*, CAL. CORP. CODE § 25142 (West Supp. 1981).

37. SEC Release No. 312, *supra* note 4, at —, 1 FED. SEC. L. REP. ¶ 2182. The SEC has left the issue of what constitutes adequate notice to be resolved in each situation. *Id.* *See also* Rapp, *supra* note 26, at 21 & n.312. The notice requirements of rule 23(e) of the Federal Rules of Civil Procedure give adequate notice. *See* Mackey Int'l, Inc., SEC No-Action Letter (Mar. 27, 1974).

38. OHIO REV. CODE ANN. § 1707.04(A) (Page Supp. 1980). *See generally* Rapp, *supra* note 26, at 21-24.

39. *See, e.g.*, Peoples Mid-Illinois Corp., SEC No-Action Letter (Aug. 16, 1971), *reprinted in* [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,397.

sons proposed to be issued securities have an opportunity to participate in the hearing.⁴⁰ The SEC has not addressed whether the public, or a representative thereof,⁴¹ also should have a right to participate. Arguably, such a right promotes the 1933 Act's goal of protecting investors and the public from the issuance of unregulated securities.⁴²

Finally, the approval of an exchange, if not made by a federal court, official, or agency, must be made by a body "expressly authorized by law to grant such approval."⁴³ At least four states provide such express authorization in provisions modeled after section 3(a)(10),⁴⁴ but the SEC strictly enforces this requirement and, in the past, has questioned the propriety of relying on approval by a state authority.⁴⁵ In a recent no-action letter, the SEC stated that section 3(a)(10) was unavailable because the North Dakota Insurance Commissioner did not "possess the requisite express authorization" to approve the proposed exchange.⁴⁶

Focusing upon these requirements, the cases, releases, and no-action letters merely reiterated the statutory language of the exemption and have avoided a discussion of what constitutes fairness in a section 3(a)(10) exchange transaction.⁴⁷ Similarly, commentators have ignored the substantive question of fairness.⁴⁸ Thus, no explicit definition or standard of fairness has developed despite the

40. American Investors Life Ins. Co., SEC No-Action Letter (Feb. 12, 1973).

41. Arguably, the SEC should represent the interests of the public when unregistered securities are issued. Cf. Comment, *supra* note 6, at 402-03 (In bankruptcy proceedings, SEC participation enhances the ability of the court to determine fairness.).

42. See notes 13-14 & accompanying text *supra*.

43. Securities Act of 1933, § 3(a)(10), 15 U.S.C. § 77c(a)(10) (Supp. IV 1980). See also SEC Release No. 312, *supra* note 4, at —, 1 FED. SEC. L. REP. ¶ 2183.

44. CAL. CORP. CODE § 25142 (West Supp. 1981); N.C. GEN. STAT. § 78A-30 (1981); OHIO REV. CODE ANN. § 1707.04 (Page Supp. 1980); OR. REV. STAT. § 59.095 (1979).

45. See Mann, *supra* note 26, at 1248.

46. Institutional Corp., SEC No-Action Letter (May 1, 1971), reprinted in [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,133.

47. See, e.g., Merger Mines Corp. v. Grismer, 137 F.2d 335 (9th Cir.), cert. denied, 320 U.S. 794 (1943); SEC Release No. 312, *supra* note 4, 1 FED. SEC. L. REP. ¶¶ 1281-1284; Pacwest Bancorp., SEC No-Action Letter (Oct. 24, 1979), reprinted in [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,376.

48. See, e.g., 3 H. BLOOMENTHAL, *supra* note 10; 1 L. LOSS, *supra* note 2; Mann, *supra* note 26; Rapp, *supra* note 26. But see Ash, *supra* note 5, at 17-24; Comment, *supra* note 6, at 398-408.

unequivocal statutory requirement of a hearing on fairness.⁴⁹ Absent objective criteria, therefore, a court has discretion over what to consider in determining the fairness of a section 3(a)(10) exchange.⁵⁰

A statutory analysis of section 3(a)(10) and the 1933 Act suggests that the current administration of section 3(a)(10) is improper. Although section 3(a)(10) requires notice, a hearing, and an opportunity to participate in that hearing,⁵¹ closer examination reveals that section 3(a)(10) requires the court to do more than assure mere procedural rights. Such procedural guarantees may assure disclosure, yet section 3(a)(10) does not rely on disclosure as its primary method of investor protection. Proper construction of the 1933 Act demonstrates that section 3(a)(10) relies upon, and therefore requires, a judicial determination of fairness to assure investor protection.

The registration exemptions found in sections 3 and 4 of the 1933 Act reveal that the 1933 Act looks to some means other than disclosure to assure investor protection.⁵² Congress provided exemptions for securities to be issued without full disclosure because something in the nature of the security or the transaction adequately protects the potential investor.⁵³

Section 3(a)(10) of the 1933 Act exempts a class of securities.⁵⁴ Thus, Congress perceived something about the nature of the section 3(a)(10) security that, in itself, provides sufficient investor protection, rendering section 5 disclosure unnecessary.⁵⁵ Three key elements to a section 3(a)(10) transaction are the exchange, the hearing, and the approval.⁵⁶ Any other aspect of section 3(a)(10)

49. See note 6 & accompanying text *supra*.

50. See J. HICKS, EXEMPTED SECURITIES UNDER THE SECURITIES ACT OF 1933 § 3.02[4][b], at 3-41 (1980).

51. See note 27 & accompanying text *supra*.

52. See note 16 & accompanying text *supra*.

53. See, e.g., *In re Thompson Ross Sec. Co.*, 6 S.E.C. 1111, 1118 (1940). See also Ash, *supra* note 5, at 5.

54. See note 16 *supra*; 1 L. LOSS, *supra* note 2, at 709; Ash, *supra* note 5, at 5, 25-27; Mann, *supra* note 26, at 1251.

55. See SEC Release No. 312, *supra* note 4, at —, 1 FED. SEC. L. REP. ¶ 2183 (examination and approval intended to substitute for protection otherwise available through registration).

56. See note 27 & accompanying text *supra*.

merely qualifies one of these three basic elements.⁵⁷

First, the element of exchange does not, in itself, provide the basis for the section 3(a)(10) exemption. The 1933 Act rejects the theory that investors, prior to exchanging valuable consideration for a security, will seek and secure adequate disclosure of material information to protect themselves.⁵⁸ Similarly, the element of a hearing does not assure investor protection. Although a hearing may facilitate disclosure, the mere existence of a hearing cannot guarantee that all information required for a reasoned investment decision will be disclosed. Finally, the SEC has explained that the "whole justification" for the section 3(a)(10) exemption is "examination and approval" by a court.⁵⁹ The drafters' insistence that nonfederal bodies must be "expressly authorized" to approve a section 3(a)(10) exchange reinforces this interpretation.⁶⁰ Thus, legislative history and logic support the SEC view that active judicial scrutiny in determining the fairness of an exchange is the means contemplated by Congress to assure investor protection in a section 3(a)(10) transaction.⁶¹

SEC v. Blinder Robinson & Co.

Fairness Criteria

In *SEC v. Blinder Robinson & Co.*⁶² the SEC brought an enforcement proceeding against Blinder Robinson & Co. and other defendants for alleged violations of the substantive provisions of the 1933 and 1934 Acts in connection with a public offering of securities.⁶³ Rather than proceed further, the SEC approved a con-

57. For example, the term "expressly authorized" further defines the type of approval; "outstanding securities, claims or property interest" further defines the type of exchange; "right to appear" further defines the type of hearing. See note 26 & accompanying text *supra*.

58. See H.R. REP. No. 85, *supra* note 11, at 1-3.

59. See SEC Release No. 312, *supra* note 4, at ___, 1 FED. SEC. L. REP. ¶ 2183.

60. *Id.*

61. See, e.g., Ash, *supra* note 5, at 3; Glickman, *The State Administrative Fairness Hearing and Section 3(a)(10) of the Securities Act—Some Questions*, 45 ST. JOHN'S L. REV. 644, 649-52 (1971); Mann, *supra* note 26, at 1252; Comment, *supra* note 6, at 383-84; Comment, *Effect of Section 3(a)(10) of the Securities Act as a Source of Exemption for Securities Issued in Reorganizations*, 45 YALE L.J. 1050, 1075 (1936).

62. 511 F. Supp. 799 (D. Colo. 1981).

63. *Id.* at 800.

sent settlement⁶⁴ in which existing and former shareholders were to receive new shares of common stock and promissory notes in exchange for their outstanding claims against the defendants.⁶⁵ The parties to the settlement then sought court approval of the exchange to ensure that the proposed issuance of securities would be exempt from the registration requirements of section 5 of the 1933 Act by virtue of section 3(a)(10).⁶⁶

Recognizing that no "general guidance" or criteria were available, the district court in a memorandum opinion formulated an original standard for determining fairness in a section 3(a)(10) exchange.⁶⁷ Initially, the court excluded any consideration of value as a criterion of fairness, stating that the factors to be considered were:

- (1) the recommendations of counsel; (2) the scope of the discovery record as an indicator of the adequacy of the investigation into the facts; (3) the apparent alternatives to the settlement; (4) the nature and volume of responses from those receiving notice of the hearing; and (5) the opportunity for direct participation in the process of obtaining full disclosure.⁶⁸

The court in *Blinder Robinson* specifically noted that the agreement was a product of arms-length bargaining; that the scope of discovery demonstrated an adequate investigation into the facts; that without a settlement, the defendant's business venture would be impaired and complete restitution to the shareholders would be impossible; that the lack of response to notice suggested a perception of fairness among the offerees; and that all affected persons had a full and fair opportunity to secure full disclosure.⁶⁹ The court concluded, therefore, that the consent settlement complied

64. For a discussion of SEC settlement policies, see Hazen, *Administrative Enforcement: An Evaluation of the Securities and Exchange Commission's Use of Injunctive and Other Enforcement Methods*, 31 HASTINGS L. REV. 427, 450-51 (1979); *SEC's Use of Settlements Still Solidly Supported by a Majority of Commissioners*, 493 SEC. REG. & L. REP. (BNA) A-6 (March 7, 1979).

65. 511 F. Supp. at 800.

66. *Id.*

67. *Id.* at 801.

68. *Id.*

69. *Id.* at 801-02.

with section 3(a)(10) and was exempt from registration.⁷⁰

In ordering that the issuance and exchange be approved,⁷¹ the court in *Blinder Robinson* identified disclosure as the primary means by which section 3(a)(10) assured investor protection. The court reasoned that the fairness hearing was the "functional equivalent" of the disclosure required by the 1933 Act.⁷² The court recognized that risks might remain for those accepting the offer, but the court insisted that it had fulfilled its responsibilities under section 3(a)(10) in its consideration of fairness.⁷³

Fairness Criteria: Inadequacy

Before discussing the factors to be considered in determining fairness, the court in *Blinder Robinson* summarily concluded that the "fairness of the offer does not depend upon [value]."⁷⁴ Although value, like fairness, is an imprecise concept,⁷⁵ whether an exchange is fair must depend to some extent on the relative value or worth of the consideration being exchanged.⁷⁶ In fact, one commentator has suggested that value may be the only relevant consideration in determining fairness within the meaning of section 3(a)(10).⁷⁷ The court's refusal to determine the value of the common stock and promissory notes evinces a presumption by the court that fairness did not require a substantive examination of the exchange. As a result, the fairness criteria developed by the court focused upon procedural aspects of disclosure rather than substantive elements of the exchange. The factors enumerated by the court in making its determination of fairness revealed substantial reliance on procedural guarantees. Specifically, the court relied on the recommendations of counsel, the scope of discovery, the lack of response to notice, and the opportunity to participate in the fairness hearing.⁷⁸ Rather than make an examination of the

70. *Id.* at 802.

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.* at 801.

75. See, e.g., *Cummings v. National Bank*, 101 U.S. 153 (1879).

76. Ash, *supra* note 5, at 22-23.

77. Comment, *supra* note 6, at 398.

78. 511 F. Supp. at 801.

fairness of the actual terms of the exchange, the court focused upon the fairness of the dealings between the parties.

Moreover, the court's discussion of the alternatives to settlement⁷⁹ typified its approach to the fairness issue. The court perhaps viewed *Blinder Robinson* primarily as a settlement case rather than as a section 3(a)(10) exchange involving securities and requiring court approval. Arguably, the court in *Blinder Robinson* applied basic tenets of compromise and settlement law to its formulation of the fairness criteria.⁸⁰ In discussing the fairness factor of alternatives to settlement, the court emphasized the inability of investors to gain complete restitution.⁸¹ Under the basic tenets of settlement law, the likelihood of recovery is the most important factor in determining whether a settlement is fair, reasonable, and adequate.⁸² Approaching the fairness issue from this standpoint, the court in *Blinder Robinson* merely reviewed the evidence relating to the parties' dealings⁸³ and did not consider the substance of the exchange. Although such a passive approach may be adequate, and perhaps desirable, in traditional settlement cases,⁸⁴ it is wholly inadequate when securities issues also are involved.⁸⁵ When security exchanges are at issue special attention by the approving court is required.⁸⁶

Finally, the court's insistence on equating fairness with disclosure demonstrated the inadequacy of the court's treatment of the

79. *Id.* at 801-02.

80. See, for example, *Siegal v. Realty Equities Corp.*, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,102 (S.D.N.Y. July 30, 1973), in which the court enumerated four factors to guide approval of a proposed settlement: "(1) that the settlement is not collusive but was reached after arm's-length bargaining; (2) that counsel for the proponents are experienced in similar cases; (3) that there had been sufficient discovery to enable counsel to act intelligently; and (4) that the number of objectants or their relative interest is small." *Id.* ¶¶ 94,102, 94,445-94,446 (footnotes omitted).

Similarly, the general criteria usually applied in determining whether a settlement is fair, reasonable, and adequate are: "(1) likelihood of recovery; (2) recommendation and experience of counsel; (3) amount and nature of discovery; (4) future expense and likely duration of litigation; (5) recommendation of neutral parties; (6) number of objectors." 3 H. NEWBERG, *NEWBERG ON CLASS ACTIONS* § 5610 (1977).

81. 511 F. Supp. at 802.

82. 3 H. NEWBERG, *supra* note 80, § 5610.

83. 511 F. Supp. at 801-02.

84. *Glicken v. Bradford*, 35 F.R.D. 144, 151 (S.D.N.Y. 1964).

85. See *J. Hicks*, *supra* note 50, § 3.02[4][b], at 3-43.

86. *Id.*

fairness issue in *Blinder Robinson*.⁸⁷ An argument can be made that disclosure, and not fairness, is the means by which investor protection is achieved under section 3(a)(10).⁸⁸ Such a contention is defensible only if a court assures that the disclosure provided in a section 3(a)(10) action is equal in quality to that required by section 5 of the 1933 Act.⁸⁹ Arguably, section 5 establishes a federal minimum for disclosure,⁹⁰ but the *Blinder Robinson* criteria fail to meet that minimum. The recommendations of counsel and the scope of discovery suggest some degree of disclosure but give no assurance that material information will be received by individual shareholders. Similarly, the opportunity to participate in a hearing does not guarantee disclosure to all interested persons; only those interested persons who attend the hearing have the opportunity to gain full disclosure.

The court in *Blinder Robinson* approached the fairness requirement of section 3(a)(10) in a manner similar to the SEC's current handling of the exemption⁹¹ and so construed fairness⁹² as requiring the possibility of disclosure. Such an interpretation is inaccurate; even if section 3(a)(10) contemplates only disclosure, the *Blinder Robinson* criteria are inadequate to assure complete disclosure and, therefore, are inconsistent with the purpose of the 1933 Act.

87. See note 72 & accompanying text *supra*.

88. Such an argument can be based upon the 1933 Act's emphasis on disclosure. H.R. REP. No. 85, *supra* note 11, at 3-4.

89. To protect investors, § 5 of the 1933 Act requires the disclosure of specific issuer information. 15 U.S.C. § 77aa (1976).

90. Certain securities and transactions are exempt from the registration requirements of § 5 of the 1933 Act under other sections of the Act, *e.g.*, Securities Act of 1933, § 4, 15 U.S.C. § 77d (1976), but for the securities to qualify for the exemption, an investor must receive, or have access to, the same information that is contained in a registration statement. See, *e.g.*, *Doran v. Petroleum Management Corp.*, 545 F.2d 893 (5th Cir. 1977); 17 C.F.R. § 230.146 (1981) (Rule 146).

91. See notes 34-50 & accompanying text *supra*.

92. Commentators have suggested that the lack of an explicit definition of fairness is due to the vagueness of the concept and the flexibility possible without such a definition. See generally Ash, *supra* note 5, at 17; Comment, *supra* note 6, at 399.

THE ROLE OF THE COURT

Fairness and Judicial Scrutiny

Section 3(a)(10) requires judicial "examination and approval" of the exchange transaction.⁹³ The extent of the court's involvement is defined by the requirement of a "hearing upon the fairness of such terms and conditions" of the exchange.⁹⁴ The role of the court in approving a section 3(a)(10) exchange necessarily is tied to the concept of fairness. Thus, the approach to or standard of fairness adopted by a court controls the degree of judicial supervision.

The fairness criteria formulated by the court in *Blinder Robinson* assured a perfunctory review of the exchange because the court focused upon fair dealing⁹⁵ and disclosure⁹⁶ and avoided any consideration of substantive requirements of fairness. In fact, the court expressly refused to examine the elements of the exchange itself.⁹⁷

Congress did not intend fairness to be equated with disclosure;⁹⁸ rather, section 3(a)(10) relies upon court approval based on fairness, as a substitute for disclosure, to achieve investor protection.⁹⁹ Moreover, a fairness determination affords the investor a degree of protection superior to that provided by disclosure.¹⁰⁰ Under the fairness theory, investors need not evaluate disclosed information.¹⁰¹ All the investor must do is decide whether to accept an offer that the court has approved as being fair.¹⁰²

Considering the pervasive emphasis on disclosure in the 1933 Act, section 3(a)(10)'s reliance on fairness is unique.¹⁰³ Nonetheless, substantive fairness is not an unfamiliar concept in American securities law. For instance, fairness has been the crux of state se-

93. SEC Release No. 312, *supra* note 4, at —, 1 FED. SEC. L. REP. ¶ 2183.

94. Securities Act of 1933, § 3(a)(10), 15 U.S.C. § 77c(a)(10) (Supp. IV 1980).

95. See note 78 & accompanying text *supra*.

96. See note 72 & accompanying text *supra*.

97. See notes 74-75 & accompanying text *supra*.

98. See notes 23-25 & accompanying text *supra*.

99. SEC Release No. 312, *supra* note 4, at —, 1 FED. SEC. L. REP. ¶ 2183.

100. See Ash, *supra* note 5, at 5-6.

101. *Id.*

102. Presumably the courts will not approve an exchange that is unfair.

103. See Ash, *supra* note 5, at 5.

curities regulation.¹⁰⁴ Some states that have enacted provisions similar to section 3(a)(10) of the 1933 Act have limited the amount of the court's discretion by establishing fairness guidelines.¹⁰⁵

In order to determine whether an exchange is fair, therefore, the court must engage in a substantive examination of the exchange. Such a requirement refutes the suggestion that only a perfunctory judicial role is required by section 3(a)(10). By misinterpreting fairness in a section 3(a)(10) exchange, the court in *Blinder Robinson* failed to scrutinize the terms and conditions of the exchange as required to assure investor and public protection.

Competence

The exemption provided in section 3(a)(10) ultimately rests on the premise that the court has the requisite expertise to scrutinize the fairness of the exchange and prevent fraudulent issuances.¹⁰⁶ The lack of an explicit definition of fairness to guide the courts has not been viewed as problematic in the administration of section 3(a)(10).¹⁰⁷ Presumably, those courts that have approved an issuance and exchange have made competent findings of fairness.¹⁰⁸ The opinion of the court in *Blinder Robinson*, however, reveals the danger of entrusting courts with the determination of fairness in section 3(a)(10) exchange transactions.

The earliest commentator on the section 3(a)(10) exemption argued vigorously that courts lacked the requisite expertise to approve exchanges involving section 3(a)(10).¹⁰⁹ In its determination of fairness criteria the court in *Blinder Robinson* evinced the potential abuse and misinterpretation of section 3(a)(10).¹¹⁰ Because judges are generalists,¹¹¹ the court's application of settlement law standards to section 3(a)(10)¹¹² is not surprising. Furthermore, courts are uncomfortable with the active role required in determin-

104. See Comment, *supra* note 6, at 404.

105. See, e.g., CAL. ADMIN. CODE tit. 10, § 260.140.61 (West 1977).

106. See Comment, *supra* note 6, at 400.

107. See Ash, *Supra* note 5, at 18.

108. *Id.*

109. Comment, *supra* note 61, at 1075.

110. See notes 79-86 & accompanying text *supra*.

111. See Comment, *supra* note 6, at 400.

112. See notes 79-83 & accompanying text *supra*.

ing fairness.¹¹³ As a result, the court in *Blinder Robinson* formulated fairness criteria that were inconsistent with the purpose of section 3(a)(10) and the 1933 Act.

Although discussion of section 3(a)(10) primarily has focused on the courts, the exemption also provides for a broad range of potential bodies, both state and federal, that may approve a section 3(a)(10) exchange.¹¹⁴ Thus, the degree of expertise will vary from one forum to the next, and if each body articulates its own fairness standards, then inconsistent and improper application of the exemption may occur.¹¹⁵

The opinion in *Blinder Robinson* is particularly unsettling because the court's approval is consistent with the current administration of section 3(a)(10). Recent no-action letters, however, suggest that even when an issuer satisfies the requirements of notice and opportunity to participate in the section 3(a)(10) hearing, the SEC disapproves of exchanges that are unfair.¹¹⁶ Thus, in addition to enforcing the procedural requirements of the section 3(a)(10) exemption, a court also must determine whether the transaction is "proper, fair and equitable."¹¹⁷

Federal Standard of Fairness

If section 3(a)(10) of the 1933 Act remains in its present form,¹¹⁸ a federal minimum standard of fairness should be formulated.¹¹⁹

113. See J. Hicks, *supra* note 50, § 3.02[4][b].

114. SEC Release No. 312, *supra* note 4, at —, 1 FED. SEC. L. REP. ¶ 2183. Such approval bodies include: Court of Session in Scotland, Georgia-Pacific Corp., SEC No-Action Letter (March 27, 1981); Supreme Court of Ontario, Hiram Walker Resources, Inc., SEC No-Action Letter (Jan. 19, 1981), reprinted in [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,796; Massachusetts Commissioner of Insurance, Massachusetts Cas. Ins. Co., SEC No-Action Letter (Dec. 12, 1980); Interstate Commerce Commission, NWS Enters., Inc., SEC No-Action Letter (Oct. 30, 1980); Oregon Corporations Commissioner, Pacwest Bancorp., SEC No-Action Letter (Oct. 24, 1979), reprinted in [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,376.

115. Cf. Ash, *supra* note 5, at 18 (if approval bodies diminish fairness standards, the SEC will be forced to promulgate a minimum standard).

116. VTR, Inc., SEC No-Action Letter (Oct. 8, 1971).

117. *Id.*

118. Commentators have questioned the efficacy of the exemption although others have argued for broad application of the exemption. Compare Comment, *supra* note 6, at 413 with Ash, *supra* note 5, at 93.

119. See Ash, *supra* note 5, at 18.

Such a standard would curb the problems of varying standards by providing every authorized body with the same objective criteria to guide its determination of fairness. Problems such as those exposed in *Blinder Robinson* would be avoided because the federal standard would reduce greatly the court's discretion in approving a section 3(a)(10) exchange transaction.¹²⁰ States should be permitted to impose a higher standard, but uniform administration of the federal minimum standard would prevent inconsistent application and, therefore, the potential for forum-shopping.

Creation of such a federal standard of fairness would be accomplished best by promulgation of an SEC rule.¹²¹ Congress charged the SEC with the task of regulating the sale and distribution of securities.¹²² The SEC may "make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of [the 1933 Act]."¹²³ Pursuant to that authority, the SEC has promulgated rules, many of which expressly define terms within provisions of the 1933 Act.¹²⁴ Thus, the most prudent remedial approach to current problems in the administration of section 3(a)(10) may be an SEC rule defining "fairness" in section 3(a)(10) transactions.

CONCLUSION

In *Blinder Robinson*, the district court formulated criteria to determine the fairness of a section 3(a)(10) exchange. Although a determination of fairness by a court is required to perfect the exemption under section 3(a)(10), prior to *Blinder Robinson* no court had attempted to define fairness under section 3(a)(10). The court in *Blinder Robinson*, however, misinterpreted the role of fairness in the provision. As a result, the court developed a standard of fairness inconsistent with the 1933 Act's ultimate goal of investor

120. See note 105 & accompanying text *supra*.

121. A rule is preferable to a release because releases lack the force of law that accompanies a rule. See *DiJulio v. Digicon, Inc.*, 339 F. Supp. 1284, 1290 (D. Md. 1972).

122. See Securities Exchange Act of 1934, § 4, 15 U.S.C. § 78d (1976).

123. Securities Act of 1933, § 19, 15 U.S.C. § 77s (1976).

124. See, e.g., 17 C.F.R. § 230.132 (1981) (defining "common trust fund" in § 3(a)(2) of the 1933 Act); 17 C.F.R. § 230.147 (1981) (defining "part of an issue," "person resident," and "doing business within" for purposes of § 3(a)(11) of the 1933 Act); 17 C.F.R. § 230.150 (1981) (defining "commission or other remuneration" in § 3(a)(9) of the 1933 Act).

protection.

Despite the inadequacies of the fairness criteria set forth in *Blinder Robinson*, the decision is consistent with the current administration of section 3(a)(10). Thus, *Blinder Robinson* exposes the potential abuse of section 3(a)(10). Unless the court takes an active role in scrutinizing the exchange, section 3(a)(10) may be used to issue unregistered securities without adequate investor protection. In light of *Blinder Robinson*, the SEC should examine its position regarding section 3(a)(10) and promulgate a federal standard of section 3(a)(10) fairness. Such a standard would define the proper role of the court and assure investor protection in exchange transactions invoking the section 3(a)(10) exemption.

B. H. M.