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Client Alert

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Reducing the Costs and Administrative Burdens of an M&A Transaction through a State "Fairness Hearing"

Whenever a bank holding company issues its stock in a merger, it must register the stock issuance with the Securities and Exchange Commission (SEC) and each state in which the shares will be issued or find an exemption from such registration. Depending on the makeup of the target company's shareholders, finding an available exemption can be challenging. If a target company's shareholders reside in multiple states, then the intrastate exemption is unavailable.[1] Likewise, if the target company's shareholders lack sufficient investor qualifications (i.e., accredited, sophisticated, etc.), then the popular exemptions provided under Regulation D of the Securities Act of 1933 (the Securities Act) are also unavailable. This is where the Section 3(a)(10) exemption and "fairness hearings" may be invaluable. Section 3(a)(10) of the Securities Act provides an exemption from registration that is infrequently employed but can significantly reduce the costs and administrative burdens for parties looking to merge when the acquiring company will offer shares of its stock as part or all of the merger consideration.

The (3)(a)(10) Exemption and "Fairness Hearings"

The 3(a)(10) exemption generally applies to offers and sales of securities in an exchange transaction in which the following conditions, among others, have been satisfied:

1. The securities are to be issued in exchange for securities, claims, or property interests and not offered for cash.[2]
2. The governmental entity that holds the fairness hearing (e.g., a state securities regulator) is expressly authorized by law to hold the hearing.
3. The governmental entity finds, before approving the transaction, that the terms and conditions of the exchange are fair to those parties that will receive the securities.
4. The fairness hearing is open to all parties that will receive the securities.
5. The governmental entity approves the fairness of the terms and conditions of the exchange.

The governmental entity that conducts the fairness hearing is primarily focused on the fairness of the transaction, both procedurally and substantively, from the standpoint of the target company's shareholders who are the recipients of the securities.

Some companies may be hesitant to subject themselves to the discretion of a state regulator charged with assessing the "fairness" of their proposed transaction. However, we have found that the pre-hearing application process fosters significant dialogue between the acquiring company's counsel and the state

[1] The federal intrastate exemption, provided under Section 3(a)(11) of the Securities Act of 1933, generally exempts any security that is offered or sold only to persons residing in a single state.

[2] The acquiring company may issue some cash in conjunction with shares, but the share component of the consideration must be a substantial element of the transaction. The SEC explained that the "partly for cash" language included in the statute is intended merely to permit flexibility in structuring the share exchange.

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regulator and tends to expose any regulatory concerns long before the date of the fairness hearing. In the interim period between applying for approval and attending the fairness hearing, the merging companies are able to respond to any concerns and provide any supporting documentation requested by the regulator. In our experience, this pre-hearing communication leads to a smooth fairness hearing and timely approval from the regulator. Another benefit is that a state regulator's conclusion that the transaction is fair can help insulate the fiduciary decisions of the target company's board. Unlike the SEC, the state regulator evaluates more than just disclosure.

Timing and Costs

The 3(a)(10) exemption is available without registration with the SEC. That means the SEC will not review or comment on the proxy statement (as they would in the case of an S-4 registration statement), and the merging parties will not, in turn, need to commit resources to responding to SEC comments. The effect is significant time and cost savings relative to an S-4 registration statement. In some cases the difference in cost can be tens of thousands of dollars. The fairness hearing process can take as little as one month from the date of filing to approval.

States that Hold Fairness Hearings

As mentioned above, one of the requirements to qualify for the 3(a)(10) exemption is that the law must expressly permit the governmental entity to approve the exchange transaction after conducting a fairness hearing and evaluating the terms and conditions of the transaction. Several states authorize fairness hearings and have adopted regulations to formally guide the process. States that have held fairness hearings include California, Oregon, Washington, Utah, Idaho, Michigan, North Carolina, and Montana. Some states have laws on the books that authorize fairness hearings but have not adopted regulations, so companies (and even some state regulators) are unaware of the availability of the exemption.

We have had success working with state regulators to conduct fairness hearings even where a state lacks regulations guiding the process. For instance, in a recent merger-of-equals transaction involving two Michigan bank holding companies, we were able to convince the Michigan state securities regulators to adopt an administrative order establishing the fairness hearing procedure.[3] Shortly thereafter, the regulators conducted a fairness hearing and approved our client's exchange transaction. We have also successfully guided clients through fairness hearings where the merging parties are incorporated in different states. Finally, we have drafted proposed regulations for clients in states where fairness hearing regulations have yet to be adopted.

As more companies see the value in the 3(a)(10) exemption, we expect state regulators to grow increasingly comfortable conducting fairness hearings and approving transactions. Given the shifting regulatory environment in Washington, DC, we also expect more states to enact statutes that authorize fairness hearings to facilitate merger and acquisition activity.

Conclusion

The 3(a)(10) exemption may be a very attractive option for companies involved in a merger or acquisition, particularly when the target company's shareholders reside in multiple states or lack certain investor qualifications. Merging companies should carefully assess the exemption given its beneficial features, including significant time and cost savings.

[3] The Order, issued by the Corporations, Securities & Commercial Licensing Bureau of the Michigan Department of Licensing and Regulatory Affairs, is available here.

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If you are interested in hearing more about the fairness hearing process or the availability of the exemption in your state, please contact us.[4]

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[4] The SEC Staff Legal Bulletin, No. 3A (CF), June 18, 2008, on this subject is available here.