Michigan Business & Entrepreneurial Law Review

Volume 5 | Issue 1

2016

3(A)(10) Financing: New Predatory Financing Using the Securities Act

Thomas S. Glassman
University of Michigan Law School

https://doi.org/10.36639/mbelr.5.1.financing

3(A)(10) FINANCING: NEW PREDATORY FINANCING USING THE SECURITIES ACT

Thomas S. Glassman

Abstract

The Section 3(a)(10) exemption of the Securities Act of 1933 is meant to exempt securities transactions where a fairness hearing by a judge or government agency's ruling replaces the usual SEC registration requirements. Recently, there has been a rise in 3(a)(10) financing schemes, where a third party investor, what I call a "3(a)(10) financier," will offer to purchase the outstanding debts of a company from its creditors in exchange for discounted, and unregistered, shares of stock. In many cases these exchanges are done with no notification to current shareholders whose value falls precipitously when the 3(a)(10) financier begins not only selling, but through a common clause in these 3(a)(10) financing contracts, also demanding that the company issue more shares to them at any time. The companies who work with 3(a)(10) financiers have, in some cases, become complicit in the scheme in order to hide these transactions from investors who provide the liquidity for the 3(a)(10) financier sell-offs. I conclude that the SEC needs to provide updated guidance on Section 3(a)(10) as well as bring significant enforcement actions to curtail this budding predatory finance scheme.

I. Introduction

The Section 3(a)(10) exemption of the Securities Act of 1933[1] ("3(a)(10)") is meant to exempt securities transactions where a fairness hearing by a judge or government agency's ruling replaces usual registration requirements. Recently, there has been a rise in 3(a)(10) financing schemes, where a third party investor, a "3(a)(10) financier," offers to purchase the outstanding debts of a company from its creditors in exchange for discounted, and unregistered, shares of stock. In traditional stock issuances, a company must file a registration statement describing the company's properties and business, the security to be offered, information about the management of the company, and financial statements certified by independent accountants.[2] However, a 3(a)(10) settlement simply requires that an action be brought against a company for "outstanding se-

1. Securities Act of 1933 §3(a)(10), 15 U.S.C. §77c(a)(10) (2012) ("Except with respect to a security exchanged in a case under title 11, 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.").

2. Securities and Exchange Commission, Registration Under the Securities Act of 1933 (2011).

curities, claims, or property interests" after which, in a fairness hearing, a judge or agency must accept or reject the terms and conditions of the settlement as "fair" to "all persons to whom it is proposed to issue the securities."[3] Those issuing the securities and those who already own the securities are afforded no such protection.

This work explores the Section 3(a)(10) exemption in greater detail. Part I discusses the background and history of the 3(a)(10) exemption. Part II introduces the modern trend of 3(a)(10) financing for small public companies. Part III discusses some of the harms of 3(a)(10) financing schemes including who 3(a)(10) financing schemes hurt. Part IV discusses the possible violations of 3(a)(10) financing schemes focusing specifically on (1) pre-settled lawsuits, (2) inequities within the settlement agreements and the probability such inequities will be accurately assessed by the court during a fairness hearing, (3) timing problems related to the fairness hearings, and (4) whether the exchanged shares may be freely tradable afterward without registration or exemption. Part V explores whether the small businesses entering into 3(a)(10) transactions may also be violating securities laws. Finally, Part VI discusses some of the potential actions that could be taken in order to better reflect the legislative intent of Section 3(a)(10) and to stop what is quickly becoming a corrupt practice. Part VI includes two recommendations for the SEC. First, the Commission must develop its guidance materials to include specific regulation about this area. This guidance should comment specifically on the use of 3(a)(10) financing schemes and whether or not, in their view, enforcement actions will be brought during the process and their interpretation of this growing practice. Next, the SEC should bring enforcement actions under Sections 5, 12, and 13 of the Securities Act against both the 3(a)(10) financier and the company for violations related to the practice of 3(a)(10) financing. Finally, it is necessary to gain congressional support to amend the Securities Act to place 3(a)(10) back into Section 4 of the 1933 Act where it was originally written and to add language in an effort to curtail the potentially unscrupulous practice of 3(a)(10) financing.

II. Legislative History and Early Commentary

In order to promote disclosure,[4] Section 5 of the Securities Act requires that all securities[5] offered or sold[6] in interstate commerce must be subject to an effective registration statement filed with the Securities and

3. *See* Securities Act of 1933, *supra* note 1.

4. H.R. Rep. No. 73-85, at 3 (1933) (President Roosevelt emphasized the importance of disclosure upon saying, "[t]here is . . . an obligation upon us to insist that every issue of new securities . . . shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.").

5. *See* Securities Act of 1933 § 2(a)(1) ("The term 'security' means any note . . . entered into on a national securities exchange relating to").

6. *Id.* § 2(a)(3) ("The term 'sale' or 'sell' shall include every contract of sale or disposition of a security or interest in a security, for value.").

Exchange Commission ("SEC") and issuers must deliver a prospectus to investors unless the transaction is exempted by a specific provision of the Securities Act.[7] Section 3, entitled "Exempted Securities," and Section 4, entitled "Exempted Transactions," provide the exemptions from registration requirements.[89] As it is currently written, the 3(a)(10) exemption exempts:

> [A]ny 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.

15 U.S.C. § 77c(a)(10). Section 3(a)(10).

The 3(a)(10) exemption is unique in that the disclosure to investors must be deemed "fair" by an objective decision maker rather than disclosing information directly to investors and letting them fend for themselves. Congress noted that "reorganizations 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."[10] A year later in March of 1935, the SEC released a statement saying that the requirement of a fairness hearing is "essential" to the exemption as it is the court who stands in the place of "those who are to receive the securities or to other security holders of the issuer, or . . . the public," and decides whether the provisions of the proposed transaction are unfair.[11]

The legislative history of Sections 3 and 4 indicates concern for the reorganization of financially troubled businesses.[12] Nothing in the congressional debates or reports suggest an exemption of mergers and acquisi-

---

7. *Id*. § 5.

8. *See id*. §§ 3-4.

9. Louis Loss, Securities Regulation 709 (2d ed. 1961).

10. H.R. Rep. No. 73-85, at 16 (1933).

11. Securities Act Release No. 312 1935 WL 29346, Fed. Sec. L. Rep. (CCH) ¶ 2181 (Mar. 15, 1935) ("This interpretation [that authorities who hold fairness hearings must have express authority of law] seems necessary to give meaning to the express requirement of a hearing upon the fairness of such terms and conditions, which must subsume authority in the supervisory body to pass upon the fairness from the standpoint of the investor, as well as the issuer and consumer, and to disapprove terms and conditions because unfair either to those who are to receive the securities *or to other security holders of the issuer, or to the public*. This requirement seems the more essential in that the whole justification for the exemption afforded by section 3 (a) (10) is that the 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.") (*emphasis added*).

12. H.R. Rep. No. 85 (1933), at 6.

tions of financially healthy companies, or for litigants who intend to use it to distribute unregistered shares as part of a compromise settlement.[13]

Part II: *Lefkowitz* and the Birth of 3(a)(10) Financing

Over its history, the 3(a)(10) exemption has been used for mergers,[14] reorganizations of companies, and settlements of private litigation. Over time, the SEC has issued no-action letters and guidance to interpret its view of when the use of 3(a)(10) is appropriate.[15] Further, the SEC guidance seems to suggest a very broad use of the 3(a)(10) exemption based on the following conditions[16]:

a. The securities must be issued in exchange for securities, claims, or property interests; they cannot be offered for cash.
b. A court or authorized governmental entity must approve the fairness of the terms and conditions of the exchange.
c. The reviewing court or authorized governmental entity must:
   i. find, before approving the transaction, that the terms and conditions of the exchange are fair to those to whom securities will be issued; and
   ii. 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.
d. The court or authorized governmental entity must hold a hearing before approving the fairness of the terms and conditions of the transaction.
e. A governmental entity must be expressly authorized by law to hold the hearing, although it is not necessary that the law require the hearing.
f. The fairness hearing must be open to everyone to whom securities would be issued in the proposed exchange.
g. Adequate notice must be given to all those persons.
h. There cannot be any improper impediments to the appearance by those persons at the hearing.

In *Lefkowitz*,[17] the SEC alleged that private litigation settlements using the 3(a)(10) exemption were for "capital raising," which was an "improper

13. 7 J. William Hicks, Exempted Transactions Under the Securities Act of 1933 § 3:2 (2d ed. 2001) ("However, the absence of legislative history has not served as an impediment and . . . exemption's protection has in recent years spread into these two areas.").

14. *See e.g.*, E. Thom Rumberger, Jr., The Acquisition and Sale of Emerging Growth Companies: The M&A Exit § 6:17 (2d ed. 2009).

15. Revised SEC Staff Legal Bulletin No. 3 (CF) (November 1, 1999); *See* SEC Staff Legal Bulletin No. 3A (CF) (June 18, 2008); *See also No-Action, Interpretive and Exemptive Letters, 3(a)(10)–Exemption for Exchanges After a Fairness Hearing*, Securities & Exchange Commission (Nov. 17, 2015), http://www.sec.gov/divisions/corpfin/cf-noaction.shtml #3a10.

16. SEC Staff Legal Bulletin No. 3A, *supra* note 15.

17. Sec. & Exch. Comm'n v. Lefkowitz, Litigation Release No. 22896 2013 WL 6794148 (Dec. 23, 2013), http://www.sec.gov/litigation/litreleases/2015/lr23206.htm [hereinafter Lefkowitz Litigation Release].

use" of the exemption.[18] The SEC stated in its complaint that Lefkowitz "developed an illegal strategy for penny stock issuers to pay off past due debts while, at the same time, raising additional capital through improper use of 3(a)(10)."[19] The SEC went on to state that "the Section 3(a)(10) exemption is not available where . . . certain terms and conditions of the settlement are not presented to the court for consideration at a fairness hearing; nor is the exemption available for capital raising."[20]

According to the SEC, the plan began in 2004, when Unico (the company issuing the stock) issued at least seventeen convertible debentures to Lefkowitz operated companies which allowed the companies to convert the debentures and accrued interest in shares of common stock at fifty percent of the closing bid price.[21] If either party requested the conversion, Unico was required to issue unrestricted shares to the debt holder, either through a transaction pursuant to a registration statement or the application of an exemption from registration.[22] At the time, Unico was a Business Development Company under the Investment Company Act of 1940 ("Company Act") and, as a result, was allowed to issue securities without filing a registration statement pursuant to the exemption from registration provided in Regulation E of the Securities Act.[23] When Unico withdrew its status as a Business Development Company, it no longer could issue unrestricted securities.[24] Lefkowitz was left in a bind as Unico was unable to pay back the debt or convert the debt into shares of common stock.[25]

Lefkowitz sought the assistance of a New York City attorney familiar with filing registration statements for penny stock issuers to determine if Unico could file a registration statement with the SEC in order to again issue shares to convert the debentures.[26] The law firm advised Lefkowitz that a registration statement could take at least eighteen months to draft and file, cost a significant amount of money, and may not be declared effective by the SEC.[27] The debentures, which were only six months in length, would surely mature by this time.[28] Lefkowitz and his counsel then discussed the option of potentially filing lawsuits against Unico for failure to "satisfy its obligations" and settling those lawsuits with shares issued under the 3(a)(10) exemption.[29] The law firm introduced Unico to inde-

18. Complaint for Injunctive Relief at 2, Sec. & Exch. Comm'n v. Lefkowitz, No. 8:12-CV-1210T35MAP (M.D. Fla. May 30, 2012).

19. *Id.*

20. *Id.*

21. *Id.* at 10.

22. *Id.*

23. *Id.* at 10–11.

24. *Id.* at 11.

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.* at 10.

29. *Id.* at 11–12.

pendent counsel in Florida to represent Unico in "pre-settled lawsuits" filed by Lefkowitz[30] and 3(a)(10) financing was born.

In a three-year span, more than fifty pre-settled lawsuits were filed under the pretext of settling past-due debts owed by the issuers.[31] For Unico alone less than $4 million in debt was converted into 8,921,335,034 shares, which, at the time they were issued, had a market value of $28,331,307.22.[32] The issuer would execute a settlement agreement with the financier pursuant to an agreement to issue unrestricted common stock to the financier at a substantial discount to the prevailing market price, purportedly to retire the past due debt.[33] The number of settlement shares reflected in the settlement agreement was always based on a negotiated discount of the market price and/or a multiple of the face value of the debt, which, in turn, meant that shares had an actual market value on the date of the settlement agreement which exceeded the amount of the past due debt.[34] Following a fairness hearing, the 3(a)(10) exemption was granted and unrestricted shares were issued to the financier who quickly sold the shares on the open market to public investors unaware of the dilutive effects of the new stock issuances.[35] The financier subsequently remitted monies to the penny stock issuer that, to the SEC, made it "a capital raising transaction."[36] On February 10, 2015, the SEC announced it had settled its civil action against all parties "arising from their respective roles in the illegal unregistered distribution of billions of shares of penny stocks."[37]

Private actions involving companies in 3(a)(10) financing arrangements have exemplified the continued complexities of such schemes.[38] Orders granting approval of settlements pursuant to 3(a)(10) show "purchase agreements" of debts made by companies who then quickly file lawsuits in

30. *Id.* at 12.

31. *Id.* at 2.

32. *Id*. at 17.

33. *Id.* at 3.

34. *Id*.

35. *Id*.

36. *Id*.

37. Sec. & Exch. Comm'n v. Lefkowitz, Litigation Release No. 23206, (Feb. 24, 2015) [hereinafter Lefkowitz 23206] https://www.sec.gov/litigation/litreleases/2015/lr23206.htm.

38. *Compare* ScripsAmerica v. Ironridge Global, 56 F. Supp. 3d 1121 (C.D. Cal. Nov. 3, 2014) (ruling against a company alleging claims of securities fraud, breach of contract, and tortious bad faith and seeking declaratory relief against a 3(a)(10) financier) *with* Ironridge Global v. Green Automotive, No. BC526570 (Cal. Super. Ct. Nov. 1, 2013) (ruling in favor of a company that completed a settlement agreement with a 3(a)(10) financier. The court awarded a temporary restraining order restricting the ability of the financier to convert their outstanding debt into additional shares per the settlement agreement. In its opposition to a motion enforcing the shares being issued, the company (defendant) claimed that the 3(a)(10) financier (plaintiff) first asked for forty million additional shares, then fifty five million, and then finally six billion shares, six times the authorized capitalization of the company.).

order to settle for shares.[39] Further, many 8-K and 10-Q/K filings since 2011 describe transactions strikingly similar to *Lefkowitz*.[40] Though the settlement agreements have different terminologies, many have similar terms and are completed in a similar way to *Lefkowitz*.[41]

In a basic 3(a)(10) arrangement, a 3(a)(10) financier brings a lawsuit against the company that will be receiving the financing. Within the initial lawsuit documents, it is stipulated that the 3(a)(10) financier is to be issued unrestricted common stock pursuant to a reduction in price from the current market value.[42] According to the SEC filings of several companies, millions,[43] and sometimes billions,[44] of shares are issued to the financier in "tranches" which can be requested at any time by the financier as long as the issuance is below either 4.99%[45] or 9.99%.[46] In press releases by companies who work with 3(a)(10) financiers, it is indicated they are using the 3(a)(10) investment for "funding."[47] Further, similar to *Lefkowitz*, companies are issuing more value in stock than the value of the debt they originally sold to the 3(a)(10) financier.[48] From start to finish, these lawsuits

39. *See, e.g.*, Court Docket Sheet, IBC Funds LLC, v Frontier Beverage Co. Inc., No. 2014 CA 002832, (Fla. Cir. Ct. June 4, 2014) (Bloomberg Law); Court Docket Sheet, IBC Funds LLC v. Healthy & Tasty Brands Corp., No. 2014-10463-CA-01, (Fla. Cir. Ct. Apr. 21, 2014) (Bloomberg Law).

40. *See e.g.*, Monster Arts Inc., Corporate Filing (Form 10-K/A) (Oct. 23, 2015); Advaxis, Inc., Corporate Filing (Form 10-Q) (Sept. 11, 2015); Epazz, Inc., Corporate Filing (Form 10-Q) (Aug. 17, 2015); Worthington Energy, Inc., Corporate Filing (Form 8-K) (Sept. 10, 2014); Jammin Java Corp., Corporate Filing (Form 8-K) (July 30, 2013); Stevia Corp., Corporate Filing (Form 8-K) (July 29, 2013).

41. Worthington Energy, Inc., Settlement Agreement and Stipulation (Form 8-K) (Sept. 10, 2014); Green Automotive Co., Current Report (Form 8-K) (May 8, 2014).

42. Worthington Energy, *supra* note 41.

43. Green Automotive Co., Corporate Filing (Form 8-K) (May 08, 2014) ("After the initial issuance GAC issued a total of 27 million additional free trading shares to Ironridge under the Stipulation formula. On or about March 28, 2014, however, Ironridge demanded GAC issue an additional 43 million free-trading shares based on Ironridge's calculations under the Stipulation."

44. Epazz, *supra* note 40 ("A total of 3,040,823,600 shares of Class A Common Stock was issued, in addition to the 75,000,000 settlement shares, in complete satisfaction of the debt. . .").

45. Worthington Energy, *supra* note 41, Ex. 10.3.

46. Jammin Java Corp., Corporate Filing (Form 10-Q) (Sept. 15, 2014) ("Additionally, as a result of each Stipulation, we agreed that at no time shall shares of common stock be issued to Ironridge and its affiliates which would result in them owning or controlling more than 9.99% of the Company's outstanding common stock.").

47. *Press Release, Green Automotive Company Closes $500,000 Investment from Ironridge Global,* MarketWatch (Dec. 5, 2013 12:00 PM), http://www.marketwatch.com/story/green-automotive-company-closes-500000-investment-from-ironridge-global-2013-12-05 ("The funding will help support the company's rollout" of new products.).

48. *See* ScripsAmerica, Inc. v. Ironridge Glob. LLC, 56 F. Supp. 3d 1121, 1135 (C.D. Cal. 2014).

can be filed and settled within one to two days.[49] One 3(a)(10) financier calls this "innovative financing structure" a way to "substantially reduce the transactional costs and time" and become a "long-term financial partner, assisting public companies in financing growth and expansion by supplying innovative funding solutions and flexible capital."[50]

III. The Harms of 3(a)(10) Financing

3(a)(10) financing is damaging to the companies being financed, the shareholders who owned the stock before the transaction(s), and the marketplace as a whole. According to SEC filings, many companies engaged in 3(a)(10) financing end up issuing between eight and forty times the original number of shares agreed upon in the settlement.[51] This flood of shares in the market could in turn make traditional offerings more difficult as it may cause potential future investors to have reasonable trepidations about investing in a company whose stock price has fallen so precipitously.

The investors who already invested in the company are damaged because their investment is devalued through dilution. Investors holding stock of a company undergoing 3(a)(10) financing will likely see a drop in share price as a result of the number of shares entering the market due to the financing agreement. Unless the company files an 8-K or other document with the SEC, the investor will likely never know the 3(a)(10) settlement happened until after the transaction is completed. Issuers may intentionally withhold information from shareholders in order to keep the stock price from falling.[52] Shareholders who are notified may sell out of their position, not because the company lacks investment potential, but because of the overwhelming number of shares which will be sold and the

49. Court Docket Sheet, IBC Funds v. Frontier Beverage Company, Inc., No. 2014CA002832AX (Fla. Cir. Ct. June 04, 2014); Court Docket Sheet, IBC Funds LLC v. Nustate Energy Holdings. Inc., No. 2014 CA 005303, (Fla. Cir. Ct. Oct. 10, 2014) (Bloomberg Law).

50. IronRidge, http://www.ironridgeglobal.com (last visited Dec. 20, 2015); see also Ironridge Global Partners Attends Rodman & Renshaw, Euro Pacific Capital; see ThruEquity and Brean Capital Conferences in New York City, MarketWatch (Sept. 6, 2012 9:11AM), http://www.marketwatch.com/story/ironridge-global-partners-llc-attends-rodman-renshaw-euro-pacific-capital-seethruequity-and-brean-capital-conferences-in-new-york-city-2013-09-06.

51. *See, e.g.*, Intellicell Biosciences, Inc., Quarterly Report (Form 10-Q) (Nov. 10, 2014) (issuing 8.5 million shares originally, eventually issuing 68,766,171.); Epazz, *supra* note 40 ("A total of 3,040,823,600 shares of Class A Common Stock was issued, in addition to the 75,000,000 settlement shares, in complete satisfaction of the debt"); *see* Seaniemac Int'l, Ltd., Quarterly Report (Form 10-Q) (Nov. 26, 2014) ("On March 21 2014, IBC received 310,000 shares; 290,000 shares represented a settlement fee in accordance with Section 3(a)(10) of the Securities Act and were valued at $0.06 per share, the March 13, 2014 closing price. Subsequent to March 31, 2014, an additional 6,403,900 shares were issued to IBC in full settlement of the acquired Company liabilities").

52. *See SEC Sanctions 10 Companies for Disclosure Failures Surrounding Financing Deals and Stock Dilution*, Sec. & Exch. Comm'n (Nov. 5, 2014) [hereinafter SEC Sanctions] http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543368026.

pressure on the company to create artificial fixes (like a reverse split), which can "renew selling pressure."[53]

The marketplace is damaged by 3(a)(10) financing because it artificially devalues the stock. While stock offerings normally indicate success in a company,[54] they are almost always dilutive.[55] It is likely companies accepting 3(a)(10) financing will not be able to absorb the type of dilution of a normal secondary offering,[56] let alone an offering in which the financier can ask for more shares to be issued as the stock price falls.[57] Worse yet, this gives the 3(a)(10) financiers no incentive to hold the stock as a typical investor might. Despite receiving the stock at a discount,[58] holding the stock is less beneficial when selling the stock drops the share price and triggers more issuances.

Bearing in mind that a rational investor would not purchase stock certain to fall in price, and considering that a company's stock price is very likely to fall because of the dilutive nature of 3(a)(10) financing, silence to the market about the deal is key to a 3(a)(10) financier. If the market knew that the purchase of a certain company's stock would trigger the issuance of more shares, thus driving down the price, it is unlikely potential investors would make purchase. Silence about a 3(a)(10) financing agreement allows a 3(a)(10) financier to sell the stock where otherwise there would be no buyer for their discounted shares.

IV. The Possible Violations of 3(a)(10) Financing

There are several potential issues presented by 3(a)(10) financing. These issues will be discussed in the order in which a 3(a)(10) financing agreement takes place. The 3(a)(10) financier and the target company enter into an agreement to file a pre-settled lawsuit in order to procure a fairness hearing.[59] Judges in 3(a)(10) financing settlements typically re-

---

53. *Reverse Stock Splits*, Sec. & Exch. Comm'n (2015), http://www.sec.gov/answers/reversesplit.htm.

54. *See generally* Richard Loth, *Why do Share Prices Fall After a Company has a Secondary Offering?*, Investopedia, http://www.investopedia.com/ask/answers/07/secondary_offering.asp (last visited Mar. 15, 2015).

55. *See generally* Rob Renaud, *What is Dilutive Stock?,* Investopedia, http://www.investopedia.com/ask/answers/06/.asp (last visited Mar. 15, 2015).

56. *See Secondary Offering*, Investopedia, http://www.investopedia.com/terms/s/secondaryoffering.asp (last visited Mar. 15, 2015).

57. *See* ScripsAmerica, Inc., v. Ironridge Global LLC, 2014 BL 314688 (C.D. Cal. Nov. 03, 2014) at 2 (describing that the settlement agreement between a 3(a)(10) financier and the company stated that if the company's shares fell a certain amount, they were required to issue more shares so that it equaled the final amount of the settlement and that at any time, the 3(a)(10) financier could request the issuance of additional shares subject to a calculation based on the share price on the day before the court verified the fairness of the settlement.).

58. *See* Epazz, *supra* note 40.

59. ScripsAmerica, Inc. v. Ironridge Glob. LLC, 56 F. Supp. 3d 1121, 1132 (C.D. Cal. 2014) ("Because the shares were unregistered, Ironridge and Scrips had to obtain court approval under California and federal securities laws before a transfer of the stock could take

ceive a complaint, a list of the claims for which the 3(a)(10) financier bases the lawsuit, an answer, and sometimes a "Memorandum of Law."[60] The settlement agreement typically allows the 3(a)(10) financier to request more discounted shares of stock as the price goes down and contains an "adjustment mechanism" to determine the exact amount.[61] In a timeframe as short as one to two days, the judge pronounces the settlement transaction agreement "fair" to those who will be *receiving the securities* (the 3(a)(10) financier).[62] After the agreement, the 3(a)(10) financier sells the securities in the open market, thus diluting the current shareholders value.[63]

A. *Pre-Settled Lawsuits*

In *Lefkowitz*, the SEC accused a financier of settling lawsuits "under the pretext" of settling past-due debts, but in actuality the shares exchanged were in "pre-settled" lawsuits.[64] In other words, the exchange of equity for debt relief (the "transaction") was already settled *before* the 3(a)(10) financier filed the lawsuit against the company. It stretches the bounds of gullibility to believe the financiers in such transactions are not filing the lawsuits for the sole purpose of meeting 3(a)(10)'s requirement that the transaction must be for a "bona fide" claim.[65] While it seems that any justiciable allegation will suffice,[66] there was at least one instance in which the SEC did not provide no-action protection in a 3(a)(10) settlement because the issued securities pertained to a future contract that had not taken place yet.[67] To the SEC, it appeared as though the company had simply signed a bad, more expensive than bargained for, contract and was attempting to use 3(a)(10) to finance the deal.[68] The SEC later said they would not recommend action in regards to the exchange after the company corrected its facts to state that the contract had already caused the company to "default."[69] It can be inferred that while the definition is very

place. Thus, on October 11, 2013, Ironridge filed a breach of contract complaint in Los Angeles Superior Court that sought to collect the accounts payable debts; it sued as the successor in interest to Scrips' creditors under receivables purchase agreements into which it had entered with the creditors.").

60. *Memorandum of Law*, IBC Funds LLC v. Healthy & Tasty Brands Corp., No. 2014-010463-CA-01 (Fla. Cir. Ct. May 6, 2014) (Bloomberg Law).

61. *See* ScripsAmerica, Inc. v. Ironridge Global LLC, 56 F. Supp. 3d 1121, 1132 (C.D. Cal. 2014).

62. Hicks, *supra* note 13, § 3:1.

63. *See generally* SEC Sanctions, *supra* note 52.

64. *See* Complaint for Injunctive Relief, *supra* note 18, at 2.

65. 15 U.S.C. § 3(a)(10) (2012);

66. Hicks, *supra* note 13, at § 3:9 ("Presumably, any justiciable allegation will suffice as long as it relates to an actual injury and thus to an outstanding claim.").

67. Carex Int'l Inc., SEC No-Action Letter, 1975 WL 9531 (Sept. 10, 1975).

68. *Id.*

69. Carex Int'l Inc., SEC No-Action Letter, 1975 WL 11284 (Oct. 30, 1975).

broad, the "bona fide" debts required by 3(a)(10), must have caused the sort of financial stress 3(a)(10) was written to relieve.[70] A court may find, in line with the legislative intent, that a claim may not be bona fide if the company would not default but for the 3(a)(10) settlement.

Negotiations between the parties before the settlement, indeed before the assignment of the claims, may cut against the fairness requirement of 3(a)(10). Both the SEC and the courts have mostly avoided a definition of "fairness."[71] In discussing the factors to include in "fairness," the court in *Blinder* took judicial notice of the "adversarial" proceeding stating that "[t]here is nothing to suggest any collusion in the preparation and submission of the agreement."[72] In quoting *Blinder,* other courts have mentioned how "hotly contested" the settlement agreement was and how "the parties could not even agree on who should participate in the settlement negotiations" when deciding whether it was fair.[73] This is in stark contrast to a 3(a)(10) financing settlement in which the parties are almost never adversarial, let alone at odds; the settlement is introduced by the financier to the target company as a banker pitches a loan.[74] The target company agrees before the debt is even assigned to the 3(a)(10) financier.[75] The financier's "complaint" and the company's "answer" are then manufactured for the fairness hearing.[76]

At least one court has stated that it is "clear that Section 3(a)(10) does not provide a mechanism for obtaining a fairness hearing."[77] The "authority must come from somewhere" and the court has inherent authority to

70. Securities Act Release No. 312, *supra* note 11 (stating that the "whole justification" for § 3(a)(10) was that "the 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.").

71. Bruce Matson, *Fairness Requirement in Section 3(a)(10) of the Securities Act of 1933*, 23 WM. & MARY L. REV. 549, 555 (1982) ("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.").

72. Sec. & Exch. Comm'n v. Blinder Robinson & Co., 511 F. Supp. 799, 801 (D. Colo. 1981) ("To the contrary, it is apparent that these attorneys have represented the interests of their clients aggressively throughout this case; that the settlement is the product of arms-length bargaining; and that their recommendation that this court accept this agreed resolution of the disputed issues results from their exercise of professional judgment as to what is in the best interests of those for whom they appeared.").

73. S.E.C. v. Founding Partners Capital Mgmt., 2:09-CV-229-FTM-29, 2014 WL 2993780, at *13 (M.D. Fla. July 3, 2014).

74. Dan Lonkevich, *Ironridge Breathes Life Into Debt Exchanges*, DEAL PIPELINE (Apr. 25, 2014), http://ironridgeglobal.com/newsroom/Ironridge-Breathes-LIFE.pdf ("We call the other side to see if it's workable. . .We only do consensual deals. We're the Warren Buffet of microcap financing.").

75. *Id*.

76. *Id.*

77. Cont'l Assurance Co. v. Macleod-Stedman, Inc., 694 F. Supp. 449, 467 (N.D. Ill. 1988).

approve a "settlement of litigation."[78] The court found that it was appropriate to rule on the fairness of the settlement because 3(a)(10) "was intended primarily to offer financially troubled corporations an alternative to the burdens of registration."[79] In 3(a)(10) financing, the company was not looking to avoid the "burdens of registration," but rather was offered an opportunity to alleviate some of its debt by paying off its creditors with its own equity shares.[80]

B. *Settlement Agreement*

Even if the settlement agreement is provided to the court[81] it may still not provide everything the judge needs to make a decision. For instance, in *Lefkowitz*, the SEC found that the 3(a)(10) financier was intentionally leaving out the "true value" of the settlement agreement and a side agreement to remit gains from the sale of the stock back to the company.[82] At no point was the presiding judge made aware of the "market value of the settlement shares," much less that the market value of those shares "exceeded the debt being extinguished by multiples."[83] While the court is shown to be aware of the total amount of the claims (through purchase agreements submitted to the court), the court is often not made aware of the value of the shares or the calculation by which they are further distributed after the date of the settlement.[84] As one court put it, "the reviewing court 'must have sufficient information before it to determine the value of both the securities, claims or interests to be surrendered and the securities to be issued in the proposed transaction.' "[85] When reviewing the terms of a 3(a)(10) financing settlement agreement, it is not possible for a judge (or

78. *Id.*

79. *Id.*

80. *Id.*

81. *See e.g.*, IBC Funds, LLC v. Entertainment Arts Research, Inc., No. 2014-CA-3839-NC (12th Cir. Jul. 25, 2014).

82. *See* Complaint for Injunctive Relief, *supra* note 18, at 24.

83. *See id.* at 34.

84. *See* Lefkowitz Litigation Release, *supra* note 17.

85. Brio Capital, LP v. Sanswire Corp., 2013 BL 130496, at *2 (S. Ct. May 9, 2013) ("In determining the fairness of a settlement involving issuance of exempt shares under the Securities Act, the totality of the circumstances should be considered. According to the SEC Staff Bulletin, the court must make an affirmative finding that the exchange is fair to the shareholders (SEC Staff Bulletin § 4[B][1]), and the reviewing court "must have sufficient information before it to determine the value of both the securities, claims or interests to be surrendered and the securities to be issued in the proposed transaction." (Id., § 4[B][2] [internal quotation marks and footnote omitted]; see Matter of Board of Directors of Multicanal S.A., 340 BR 154, 168 [SD NY 2006] [describing the SEC Staff Bulletin as "[t]he most authoritative description of the requirements of§ 3[a][10]."].) In making such findings, factors to be considered include the extensiveness of the litigation to date, the likelihood of success on the merits of the claims and defenses, the availability of public information about the financial condition of the defendant, the ability to precisely value the stock at issue, and the costs of ongoing litigation. (See Matter of TradePartners, Inc. Investor Litigation, 2008 WL 4911797 [WD Mich 2008]; Continental Assurance Co., 694 F Supp 449 [ND Ill 1988].).").

state agency) to determine the total number of shares or their value because 3(a)(10) financiers are able to request a nearly infinite amount of shares as the share price continues to fall.

C. *Time Issues*

Even if it were possible for all relevant and useful information to be included in a 3(a)(10) financing settlement agreement, there would still be a question as to the ability of judges in these fairness hearings to properly understand the transaction at hand. It is important to remember that this process is meant to take the place of traditional registration, a process that can take many months.[86] In a 3(a)(10) financing hearing, the court can receive the complaint, the proposed settlement agreement, and the debt claim purchase agreements and approve the settlement agreement in as little as one to two days.[87]

Further, some courts in which 3(a)(10) financing hearings often take place hold a "five minute motion calendar," which requires that attorneys make a good faith effort to resolve the issue within five minutes.[88] It has been implied that a statutory analysis shows that this sort of use of 3(a)(10) is improper—that a fairness hearing should go beyond "procedural fairness"—because the 3(a)(10) exemption requires a judicial determination of fairness to assure investor protection.[89] It is extraordinarily unlikely that a court receiving a complaint, answer, and sixty-seven page claim purchase agreement, is able to resolve whether or not the deal is fair (in one or two days) with the same level of scrutiny as would be achieved with registration statements filed with the SEC.[90] In order to properly protect companies and shareholders, a court must look over all material documents and be able to address any issues therein. Two days to review what can be hundreds of pages of documents and a five-minute hearing simply cannot provide the same level of protection as traditional SEC registration.

---

86. *See* Complaint for Injunctive Relief, supra note 18, at 11.

87. Notice of Hearing, IBC Funds LLC v. Healthy & Tasty Brands Corp., No. 2014-010463-CA-01 (Fla. Cir. Ct. Apr. 30, 2014) (Bloomberg Law).

88. *Id.* ("The undersigned attorney certifies that a good faith effort to resolve the matter was made prior to scheduling the hearing and that the issues can be resolved within the court's 5 minute motion calendar.").

89. *In re* Bd. of Directors of Multicanal S.A., 340 B.R. 154, 171 (Bankr. S.D.N.Y. 2006).

90. Court Docket Sheet, IBC Funds LLC. V. Nustate Energy Holdings Inc., No. 2014CA005303AX, (Fla. Cir. Ct. Oct. 09, 2014) (Bloomberg Law).

D. *Are 3(a)(10) Settlement Shares Able to be Freely Traded After a Fairness Hearing Approved the Settlement Agreement?*

In a transaction that avoids Section 5 disclosures by relying on the 3(a)(10) exemption, there must be an exchange of a bona fide security.[91] In 1934, Section 3(a)(10) was pulled from Section 4 and placed under Section 3 in what has been coined a "legislative accident" as Section 3 deals with securities exemptions and Section 4 deals with exemptions of transactions.[92] This may be seen as a distinction without a difference, but it speaks to a very serious question as to whether the securities may be freely resold after the transfer. Just two years after the 1934 Act passed, Congress remarked that "[b]y placing these exemptions under section 3 it is made clear that securities entitled to exemption on original issuance retain their exemption; if the issuer is not obliged to register in order to make the *original distribution*, dealers within a year are subject to no restriction against dealing in *the securities.*"[93] (emphasis added).

In the past the SEC has been inconsistent regarding its position on a financier's ability to resell 3(a)(10) settlement shares. The Commission has issued competing no-action letters: (1) not allowing resale by non-affiliates unless they relied on a separate exemption and did not receive "substantial" shares,[94] (2) declaring that subsequent resale could only be "affectuated pursuant to registration under the Act or suitable exemption"[95] and, (3) most recently, allowing the shares to be resold by the party receiving

91. Securities Act of 1933 § 3(a)(10), 15 U.S.C. §77c(a)(10) (2012) (noting that a bona fide security exchange is 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.).

92. *See* Loss, *supra* note 9.

93. Letters of Gen. Counsel Discussing Application of Section 3(a)(9), SEC Interpretive Letter, Securities Act Release No. 646, 11 Fed. Reg. 10,956 (Feb. 3, 1936) (emphasis added); *see also* H. R. Rep. No. 1838, at 40, 73d Cong., 2d Sess.(1934) 40. *See also* 15 U.S.C. 77b(a)(12) ("The result is in line with the Commission's interpretation of the act as it stood before, but the amendment removes all doubt as to its correctness."); 15 U.S.C. §77b(a)(12)); ("The term 'dealer' means any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person.").

94. Koracorp Industries, Inc., SEC No-Action Letter, 1976 WL 12581 (Aug. 22, 1976) ("With respect to any public resales of the shares received upon distribution, we will not raise any question if persons who are not affiliates of Koracorp and who do not receive a substantial portion of the shares distributed pursuant to the settlement resell their shares in reliance upon the exemption from registration provided by Section 4(1) of the Act.").

95. Weatherford Int'l Inc., SEC No-Action Letter, 1976 WL 12594 (Aug. 13 1976) ("While the exemption provided by Section 3(a)(10) of the Act may be available for shares issued in settlement of a claim where the fairness of the settlement has been approved by a Court, it is our view that the transactional exemption provided by that section does not extend to subsequent resales of the securities acquired. Such resales can only be effectuated pursuant to registration under the Act or suitable exemption." Further, even when a subsequent exemption for resale is provide by Section 4(1), the "rationale" of the act should be "interpreted to permit only routine trading transactions as distinguished from distributions. Therefore, a person reselling securities under Section 4(1) of the Act must sell the securities

the shares if they were a non-affiliate because the presumptive underwriter rule was amended.[96] Consistently, however, the SEC has advised that non-affiliates receiving shares could resell them as long as they did not receive a "significant number" of shares.[97] By any reasonable standard, 3(a)(10) financiers are receiving a significant number of shares.[98]

Most courts have found that there needs to be a separate registration or exemption in order to resell 3(a)(10) securities. In *Multicanal* the Federal Bankruptcy court analyzed, and eventually remanded to a lower court, the question of whether a section 4(2) exemption was needed to be able to sell the securities received freely after the exchange.[99] In *Continental Insurance* the court found that "since the statute is designed [for]. . .an unsettled dispute" the court can exercise its jurisdiction to provide a fairness hearing.[100] However, the court "does not believe it to be appropriate

in such limited quantities and in such a manner so as not to disrupt the trading markets."); Carex Int'l Inc., 1975 WL 11283, at *2 (July 7, 1975).

96. 17 C.F.R. § 230, 239 (2008); The amendments to Rule 145, among other things, eliminated the presumptive underwriter provision in Rule 145(c). The SLB states that, because securities received in a Rule 145(a) transaction that was exempt under Section 3(a)(10) would not constitute "restricted securities" within the meaning of Rule 144(a)(3), those securities may generally be resold without regard to Rule 144 if the sellers are not affiliates of the issuer and have not been affiliates within 90 days of the date of the transaction. In the event that the securities are held by affiliates of the issuer, those holders may be able to resell the securities in accordance with Rule 144. Accordingly, the shares issued in accordance with above judgment are free trading as set forth above. Comment Letter from Compliance Systems Corp to the SEC Staff (Jan. 22, 2013).

97. A recipient of Section 3(a)(10) settlement securities that were not restricted was advised that immediate resale under Section 4(1) was permissible so long as that person (1) was not an affiliate and (2) did not receive a "substantial amount" of securities in relation to the amount of securities issued in the settlement. *See*, *e.g.*, General Pub. Utils. Corp., SEC No-Action Letter, 1983 WL 28493 (June 29, 1983); The SEC staff consistently refused to express any view as to what constituted a substantial amount of securities in a nonaffiliate's hands, "since the issuer and its counsel are in the best position to ascertain the facts and make the requisite determination." April Indus., Inc., SEC No-Action Letter, 1977 WL 14073 (Feb. 18, 1977); *see also* International Tel. & Tel. Corp., SEC No-Action Letter, 1977 WL 10567 (June 17, 1977); Delhi Int'l Oil Corp., SEC No-Action Letter, 1977 WL 10620 (Feb. 25, 1977); WILLIAM J. HICKS, 7 EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 § 3:84 n. 3 (Clark Boardman Co., 7th ed. 1979).

98. *See* IronRidge Global LTD v Green Automotive Co., Docket No. BC526570 (Cal. Super. Ct. Nov. 01, 2013) (requesting for the shares, the 3(a)(10) financier wrote the defendant, "[b]ased on the stock drop [after our initial issuance], you now owe over 6 billion (with a Carl Sagan 'b') shares.").

99. *In re* Bd. of Directors of Multicanal, S.A., 340 B.R. 154, 159 (Bankr. S.D.N.Y. 2006) ("On remand, Multicanal argues that an exemption under § 3(a)(10) is available and that the record is sufficient to include the fairness finding required by that provision. Multicanal also contends that since the securities to be issued to the U.S. retail holders will be covered by the Registration Statement and the securities issued to the 'yes' voting noteholders will be covered by Section 4(2) of the Securities Act of 1933, 15 U.S.C. § 77d(2), there will be no discrimination, and all of the issued securities will be fungible and freely tradable.").

100. Cont'l Assurance Co. v. Macleod-Stedman, Inc., 694 F. Supp. 449, 467 (N.D. Ill. 1988).

to hold that the new securities are not subject to registration."[101] By its reading, the court found that the only requirement of a fairness hearing is that the court approve the "terms and conditions of the exchange," but "an express determination as to the necessity for the registration is more appropriately left to the SEC or any future disputes that may result from the exchange of securities."[102] Most recently, five different defendants in connection to the 3(a)(10) financing scheme in *Lefkowitz*, were all found to be in violation of Section 5 of the Securities Act of 1933, which requires public distributions of securities to be conducted pursuant to an effective registration statement filed with the Commission or pursuant to a valid and properly invoked exemption from registration.[103]

Most academics are in favor of requiring additional registration or exemptions for resale. The 3(a)(10) exemption is "not based on the nature of the security" and operates "more like a transaction exemption."[104] More than that, "the weight of authority leaves no doubt that 3(a)(10) is and should be a transactional exemption only."[105] The main reason is that the fairness hearing may protect the initial investors who receive the shares, but it does not provide assurance to the secondary purchasers like the protection afforded by a prospectus.[106]

The SEC itself has argued that 3(a)(10) financing companies are actually unregistered dealers and are therefore in violation of Section 15(a)(1) of the Exchange Act.[107] A "dealer" is someone who is "engaged in the business of buying and selling securities. . .for a person's own account through a broker or otherwise."[108] While the issue has not been fully ad-

---

101. *Id*.

102. *Id.*

103. *See* Lefkowitz 23206, *supra* note 37.

104. Thomas Lee Hazen, Exemptions from the Securities Act Registration Requirements – General Considerations 51-52 (2007), http://files.ali-aba.org/files/coursebooks/pdf/CM052_chapter_06.pdf ("Sections 3(a)(9), 3(a)(10), 3(a)(11), 3(b), 3(c) all operate more like transaction exemptions—i.e. the exemption is not based on the nature of the security being issued and thus does not apply to every transaction in those securities. For example, downstream resales may need a new exemption or else face registration. . . Section 4 identifies transactions which are exempt from registration. Thus, the crucial issue is the structure of the transaction in which the securities are issued . . . In 1996, Congress added section 28 of the Securities Act which gives the SEC broad exemptive power not tied to specific types of securities or transactions . . . Under this provision, the Commission may adopt rules or regulations conditionally or unconditionally exempting any person (or class of persons), any security (or class of securities) or any transaction (or class of transactions) "to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors. . . Scope of the exemptions—sections 3, 4, and 28 of the Securities Act are exemptions from registration. They are not exemptions from the antifraud provisions.").

105. Ash, *Reorganizations and Other Exchanges Under Section 3(a)(10) of the Securities Act of 1933*, 75 Nw. U.L. Rev. 1, 26 (1980).

106. *See id.* at 26–27.

107. *See* IronRidge Global Partners, Administrative Proceedings Rulings Release No. 3298 (ALJ Nov. 5, 2015), https://www.sec.gov/alj//2015/ap-3298.pdf.

108. 15 U.S.C. § 78c(a)(5)(A) (2012).

judicated, an Administrative Law Judge ("ALJ") did find that there were material facts that are in dispute to overcome a motion for summary disposition.[109] The case turned on whether the 3(a)(10) financier's buying and selling of securities was done as part of regular business.[110] The ALJ found that the definition of dealer "cast a wide net," and that a 3(a)(10) financier could fall under that definition based on the "totality" of a "fact-specific endeavor."[111]

V. The Devil's advocate? How much blame should appropriately be placed on the target company?

The companies accepting 3(a)(10) financing are taking a big risk. In order to keep current investors apprised of significant corporate events, public companies are required to file a Form 8-K within four business days of a "triggering event."[112] A 3(a)(10) financing scenario can be a triggering event, and there are two items under Form 8-K that must be reported to investors in such a situation: item 1.01 and item 3.02.[113] Under item 1.01, a registrant must disclose within four business days its entry into a material definitive agreement.[114] Under item 3.02, a smaller reporting company[115] must disclose a sale of unregistered securities, within four business days of the sale, unless the securities constitute less than five percent of the shares outstanding in that particular class of securities.[116]

According to the SEC, this does not mean five percent at the date of the settlement, but every time the company issues five percent or more in any tranche.[117] In 2014, the SEC filed cease and desist orders against ten companies for a combined twenty two unregistered stock sales of over five percent of total issued and outstanding stock and other violations under Exchange Act rules 13(a) and 12(b).[118] The timeline in the cease and desist orders show that the 3(a)(10) financing companies forced the compa-

109. IronRidge Global Partners, *supra* note 107.

110. *Id.* at 8.

111. *Id*.

112. *Form 8-K*, Sec. & Exch. Comm'n. http://www.sec.gov/about/forms/form8-k.pdf (last visited Mar. 15, 2015).

113. *Id.*

114. *Id*.

115. *Changeover to the SEC's New Smaller Reporting Company System,* Sec. & Exch. Comm'n (Jan. 25, 2008), http://www.sec.gov/info/smallbus/secg/smrepcosysguid.pdf (qualifying as "smaller reporting companies, ". . .if they (1) have a common equity public float of less than $75 million or (2) are unable to calculate their public float and have annual revenue of $50 million or less, upon entering the system").

116. *Id.*

117. SEC Sanctions, *supra* note 52.

118. *See id.* ("According to the orders, the companies entered in a financing agreement pursuant to which [the company] issued shares of stock to the financing company purportedly in reliance on a registration exemption found in section 3(a)(10) of the Securities Act of 1933. The financing agreement provided for obligations that were material and enforceable against [the company].").

nies to sell between 5% and over 35,000% of their outstanding stock over a period ranging from as little as one week up to several months.[119]

In *Lefkowitz*, the SEC found it compelling that the agreement between the 3(a)(10) financier and the target company was pre-settled. Any time there are two apparent adversaries entering into an agreement, there is an opportunity for fraud. Indeed, beyond not properly keeping investors informed about the 3(a)10) transactions, they were also giving kickbacks to the target company after completing the deal.[120] Criminal charges were filed against the target company for making "false and fictitious statements" in the company's filings with the SEC regarding the 3(a)(10) transactions.[121]

VI. Solutions to Allow 3(a)(10) Financing

While it has been suggested further safeguards are not necessary in 3(a)(10) transactions because fairness hearings are a good substitute for the registration process,[122] the evidence presented in previous sections indicates a need for additional safeguards to protect the system from 3(a)(10) financing. 3(a)(10) financing clearly does not benefit the target company, the investors holding securities in the target company before the 3(a)(10) transaction, or the market as a whole. For these reasons, the SEC needs to step in to protect investors.

The SEC needs to bring enforcement actions against 3(a)(10) financing companies.[123] 3(a)(10) financiers bring pre-settled lawsuits against companies in order to have a fairness hearing where normally the lawsuits re-

---

119. *See id.* (noting that in one cease and desist order, a company had been forced to sell over seven billon unregistered shares of common stock. The company failed to report the extreme nature of the dilution to shareholders for a little over a month. During this time (according to http://www.otcmarkets.com/stock/COWI/) the company's share price fell from a high of $.001 to $.0001, a 1000% percent fall, from which it had not recovered as of Nov. 6, 2015).

120. Complaint for Injunctive Relief, *supra* note 18, at 17.

121. *See* U.S. v. Unico, Inc., Deferred Prosecution Agreement, No. 3:13-CR-00355-BTM (S.D. Cal., Jan. 30, 2013), http://www.gibsondunn.com/publications/Documents/Unico_Inc_DPA.pdf.

122. Comm. *on Fed. Regulation of Sec., Integration of Securities Offerings: Report of the Task Force on Integration by the Committee on Federal Regulation of Securities*, 41 Bus. Law. 595, 636 (1985 - 1986). ("During the past fifty years, many changes in the securities laws have augmented investor protection in a number of ways. As a result, the registration process has become less important in the overall pattern of investor protection, diminishing the necessity of an interpretive policy favoring registration. In view of these developments, we believe that as a matter of policy there should also be integration safe harbors for offerings made in reliance on section 3(a)(9) or section 3(a)(10) of the Act, since, in such offerings, there is little need for the registration safeguards.").

123. Ironridge Global Partners, Securities Exchange Act of 1934 Release No. 75272 (June 23, 2015). ("This year, the SEC brought its first enforcement action against the 3(a)(10) financier ordering it to cease and desist for willful violations of Sections 15(a) and 20(b) of the Securities Exchange Act of 1934. It claimed, as I have here, that 3(a)(10) financiers are actually unregistered dealers.").

lated to these claims would be brought as part of the dispute between the parties. These suits are brought simply to use the court to transfer shares without the normal scrutiny of the registration process.[124] A company is perfectly able to purchase unpaid debt contracts and enforce agreements in other ways, but 3(a)(10) financiers are purchasing the debt only after first working out a deal for reduced-price shares. If the two companies had the ability to trade outstanding debt for shares without the courts, they probably would. 3(a)(10), however, is not intended to help companies raise capital using a fairness hearing; 3(a)(10) is intended to give those with a prior dispute an opportunity to settle by exchanging shares for bona fide claims.[125] Current 3(a)(10) transactions are in direct opposition to the legislative intent of 3(a)(10) and should be seen as outside of the 2008 SEC guidance on the appropriate use of Section 3(a)(10).[126]

The judges conducting fairness hearings only review the settlement documents for a short period of time (as little as one to two days) before the hearing, and in some cases require the hearing to be held in five minutes or less.[127] This brings into question whether the judges conduct a "fairness" hearing at all given the courts' interpretation of what the enumerated fairness elements should be.[128] Even if they did have time, the judges are left without material information, such as the market value of the shares the 3(a)(10) financier will receive.

Although unlikely, if the 3(a)(10) financier could provide the market value of the initial shares proposed in exchange for the outstanding claims, this would not satisfy 3(a)(10)'s requirement that the exchange be for "bona fide" outstanding securities because the financier most likely included a clause in the pre-settled agreement that allows them to take the shares at a discounted price, sell them freely, and collect more shares as the share price of the target company falls. But even if the securities and the hypothetical future securities were deemed "bona fide" within the language of Section 3(a)(10), a judge could find that while the fairness of the initial disbursement of shares was sound, the additional issuances of shares

---

124. Cont'l Assurance Co. v. Macleod-Stedman, Inc., 694 F. Supp. 449, 467 (N.D. Ill. 1988) ("It is clear that § 3(a)(10) does not provide a mechanism for obtaining a fairness hearing. It is not a jurisdictional or procedural statute. Authority for the hearing must come from elsewhere. This court has the inherent authority to approve a settlement of litigation. Also, under the Declaratory Judgment Act, this court has the authority to rule on the issue before it in this case or controversy. There is no jurisdictional problem, it is only a prudential problem of whether this is an appropriate case in which to act. Section 3(a)(10) was intended primarily to offer financially troubled corporations an alternative to the burdens of registration. Hicks § 3.02; Ash, *Reorganizations and Other Exchanges Under Section 3(a)(10) of the Securities Act of 1933*, 75 Nw. U. L. Rev. 1, 9 (1980).").

125. Complaint for Injunctive Relief, *supra* note 18, at 10.

126. *See* SEC Staff Legal Bulletin No. 3A, *supra* note 16.

127. *See* Court Docket Sheet, IBC Funds LLC. v. Nustate Energy Holdings Inc., No. 2014CA005303AX (Fla. Cir. Ct. Oct. 09, 2014) (Bloomberg Law); *see also* Notice of Hearing, *supra* note 87.

128. *See In re* Bd. of Directors of Multicanal S.A., 340 B.R. 154, 169-72 (Bankr. S.D.N.Y. 2006).

exchanged for debt, are not being exchanged after a fairness hearing and are therefore not freely tradable as the shares are unregistered and have not met the requirements of the exemptions of the Securities Act.

At a minimum, the SEC needs to make its guidelines more clear as to the requirements and expectations of all parties involved in 3(a)(10) financing. First, the SEC needs to officially adopt the fairness standards set forth in the case law. The court should be required to analyze: (i) the recommendations of counsel; (ii) the scope of the record as an indication of the adequacy of the investigation into the facts; (iii) the apparent alternatives to settlement; (iv) the nature and volume of responses from those receiving notice of the hearing; (v) the opportunity for direct participation in the process of obtaining full disclosure;[129] (vi) the liquidation value of the business before and after the proposed settlement; (vii) whether the settlement was of fair value; and (viii) whether the settlement was reached after fair dealing.[130] These factors will require the courts to look deeply into 3(a)(10) transactions and ferret out potential issues.

Next, the guidelines should speak specifically to whether shares may be taken by the financier after the date of the settlement and how many shares is "significant" enough to trigger the SEC's own previous guidance. Based on the 2004 Form 8-K disclosure changes requiring a company to publicly disclose when they sell unregistered shares above five percent of their outstanding shares,[131] a heightened disclosure requirement for 3(a)(10) financing companies should be implemented. If a 3(a)(10) financier were to receive more than five percent of the total outstanding shares of a company in exchange for recently purchased claims, the SEC should require that the market be made aware of the transaction, its details, the parties involved, and the potential impact to the share value before the unregistered shares are deemed exempt under Section 3(a)(10). In order to further the SEC's mission of open markets and informed investors, the financier and the issuer should be jointly responsible for informing the market.[132]

Finally, there should be congressional support to amend Section 3(a)(10). First, the exemption should be placed back in Section 4 as a transactional, rather than a security based exemption. The "legislative accident"[133] of moving 3(a)(10) out of Section 4 caused confusion about

129. Sec. & Exch. Comm'n v. Blinder Robinson & Co., Inc., 511 F. Supp. 799, 801 (D. Colo. 1981).

130. *In re* Bd. of Directors of Multicanal S.A., 340 B.R. 154, 170 (Bankr. S.D.N.Y. 2006).

131. 17 C.F.R. §§ 228–230, 239–240, 249 (2004).

132. *See* Regulation 13D-G, Securities and Exchange Commission, http://www.ecfr.gov/cgi-bin/text-idx?node=pt17.4.240&rgn=div5#sg17.4.240_113b2_62.sg29 details about the transaction if they have not already).

133. *See* Loss, *supra* note 9.

whether it was a securities or transaction based exemption.[134] Second, 3(a)(10) should be barred from use in situations where investors do not know the total number of potential shares that could be diluting their investment. This would mean, at minimum, reporting the maximum number of shares that could be exchanged in a given 3(a)(10) transaction as well as the equation used to derive that total. Also, any amendment to Section 3(a)(10) should bar provisions in a settlement agreement that would allow companies to issue additional shares to the financier without current shareholders' knowledge. This can be done one of two ways. First, require the issuing company in a 3(a)(10) transaction to notify all current shareholders of the judgment. This will serve a similar purpose as a registration statement and will notify shareholders of the potential dilution that could occur while they wait for a Form 8-K filing with the SEC. Second, the language of Section 3(a)(10) could simply state that the judge or agency needs to find the settlement terms and conditions fair to all parties involved, rather than just the party receiving the securities.

VII. Conclusion

Section 3(a)(10) of the Securities Act is meant to allow companies in dire straits a way to make good on their outstanding claims by issuing shares in exchange for bona fide outstanding claims. The investors, 3(a)(10) financiers in this context, are protected by means of a judge or agency reviewing the terms and conditions of the exchange to make sure they are fair to the investors receiving the shares of a struggling company. 3(a)(10) financing, which is a practice where the investor actively looks for companies who would like to trade its debt for discounted shares, results in the possibility of a financier receiving an almost infinite number of shares if the stock price falls. This practice not only falls outside of the legislative intent of Section 3(a)(10), but also leads to violations of Sections 5, 12, and 13 of the Securities Act of 1933. Rule makers must focus on this growing practice to blatantly skirt the traditional registration process of the Securities Act and amend Section 3(a)(10) to better protect current shareholders of the target comp any, the target company itself, and the marketplace from the harmful effects of 3(a)(10) financing.

134. *See id.* at 709 (noting that a proposal to amend the Securities Act by moving 3(a)(10) and others back into Section 4 was attempted in 1941 and again in 1959, but the proposals were eventually dropped for substitute bills).