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Definition of a Security: Long-Term Promissory Notes

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DEFINITION OF A SECURITY: LONG-TERM PROMISSORY NOTES

Plaintiff brought an action against a bank under rule 10b-5[1] of the Securities Exchange Act of 1934[2] for fraud "in connection with the purchase"[3] of a security. To pay corporate debts, the plaintiff had executed a one-year promissory note in favor of the bank for a $200,000 loan.[4] The United States Fifth Circuit Court of Appeals *held* that under the federal securities laws,[5] the note was not a "security," as it was "commercial" rather than "investment" in nature. *McClure v. First National Bank*, 497 F.2d 490 (5th Cir. 1974).[6]

1. 17 C.F.R. § 240.10b-5 (1974) [hereinafter cited as rule 10b-5], adopted under the Securities Exchange Act of 1934 [hereinafter cited as Exchange Act], § 10(b), 15 U.S.C. § 78j(b) (1970): "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." The rule operates to give sellers as well as purchasers an implied private civil remedy for "fraud" (unfairness) in dealing in securities. "10b-5 actions" are becoming increasingly popular due to the relative ease of recovery under the rule as opposed to recovery for common law fraud. *See* 3 L. LOSS, SECURITIES REGULATION 1435, 1763-77 (2d ed. 1961) [hereinafter cited as LOSS]; 2 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10B-5 § 8.1 at 195-220 (1967) [hereinafter cited as BROMBERG].

2. 15 U.S.C. § 78 (1970). Whereas the Securities Act of 1933, 15 U.S.C. § 77 (1970) [hereinafter cited as the Securities Act], provided federal regulation of the distribution of new securities, the Exchange Act extended regulation to exchanges of existing securities. Federal regulation was again extended in 1942 through rule 10b-5 to provide protection for the seller of securities when fraud was perpetrated by the purchaser.

3. 17 C.F.R. § 240.10b-5 (1974). In the instant case, there would be no federal jurisdiction under the Securities Act nor any state jurisdiction under the Louisiana Blue Sky Laws, LA. R.S. 51:715 (1940), as both protect only purchasers of securities against fraud by the seller.

4. The alleged fraud involved was that the proceeds of the loan were used, with the knowledge of the bank, to satisfy unsecured personal debts of the corporate president owed to the bank.

5. Securities Act of 1933, 15 U.S.C. § 77b (1970); Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (1970).

6. Although the district court in *McClure*, 352 F. Supp. 454 (N.D. Tex. 1973), had held that the giving of the note for a loan was not a "purchase or sale" of a security, the Fifth Circuit did not reach this issue. Past courts have avoided the definitional problem by holding the note transaction not to be a "purchase or sale." *See, e.g.*, Lino v. City Inv. Co., 487 F.2d 689 (3d Cir. 1973). However, Exchange Act § 3(a)(13) defines "purchase" to include "or otherwise acquire." 15 U.S.C. § 78c(a)(10) (1970). This language is broad enough to encompass notes executed in a loan transaction. 1 Loss 546. *Accord*, Llanos v. U.S., 206 F.2d 852 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954).

Section 3 (a) (10) of the Securities Exchange Act provides that "[t]he term 'security' means *any note.*"[7] An exception in the Act excludes from the definition "any note . . . which has a maturity at the time of issuance of not exceeding nine months. . . ."[8] Despite this seemingly clear language, courts have not mechanically applied the definition to exclude all short-term notes from federal regulation.[9] For instance, in *Zeller v. Bogue Electric Manufacturing Corp.*,[10] the Second Circuit observed that "the mere fact that a note has a maturity of less than nine months does not take the case out of Rule 10b-5. . . ."[11] Perceiving the purpose of the federal securities laws to be regulation of transactions of a speculative and investment nature,[12] the court held a note which was investment in nature to be a security, despite its short-term maturity.[13] Thus, courts have drawn a distinc-

7. (Emphasis added.) Both the Securities Act (§2) and the Exchange Act (§3) provide definitions of a "security" which contain the "any note" language. 15 U.S.C. § 77b(1) (1970); 15 U.S.C. § 78c(a)(10) (1970). The same notes which are excluded from the definition by the Exchange Act are exempted from registration under the Securities Act, but these latter notes are still covered by the Securities Act fraud provisions. 1 BROMBERG § 4.6 at 321; 2 Loss 796.

For commercial paper to be exempted from registration under the Securities Act and be excluded from regulation under the Exchange Act, it must be "[1] prime quality negotiable commercial paper [2] of a type not ordinarily purchased by the general public, that is, [3] paper issued to facilitate well recognized types of current operational business requirements and [4] of a type eligible for discounting by Federal Reserve banks." (Numerals added.) Securities Act Release No. 4412, 26 Fed. Reg. 9158 (1961); H.R. REP. No. 85, 73d Cong., 1st Sess. 15 (1933). The same requirements apply to the exclusion in section 3(a)(10) of the Exchange Act. Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795, 800 (2d Cir. 1973); 2 Loss 796.

8. Exchange Act § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1970).

9. Exchange Act § 3(a) provides that the definitions in the Act are to be used, "unless the context otherwise requires." 15 U.S.C. § 78c(a) (1970). The United States Supreme Court has instructed that "courts will construe the details of an act in conformity with its dominating general purpose, will read text in light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy." SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 350-51 (1943). The definition of a security "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946). Federal securities regulation is to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963).

10. 476 F.2d 795 (2d Cir. 1973), *cert. denied,* 414 U.S. 908 (1973).

11. *Id.* at 800.

12. *See* Tcherepnin v. Knight, 389 U.S. 332, 338 (1967).

13. *See also* Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir. 1972), *cert. denied,* 409 U.S. 1009 (1972) (short-term notes offered to the general public); Llanos

tion between commercial and investment notes and have limited the short-term exception to exclude only short-term commercial notes from the definition of a security.[14]

The subject of the instant case was a twelve-month note executed in a "commercial loan transaction." Although a literal application of the statute would have determined the note to be a security,[15] the court felt that Congress never intended to extend federal securities regulation to purely commercial settings, regardless of the maturity of the note involved; thus, the commercial nature of the twelve-month note prevented it from being a security.[16] Coupled with the earlier cases holding the short-term exception inapplicable to investment notes, the decision "depriv[es] of all utility the exemption based on maturity-length."[17] After *McClure,* jurisdiction under the Exchange Act extends to "all *investment* notes, no matter how short their maturity" and does not extend to "any *commercial* notes, no matter how long their maturity."[18]

In light of the recent decisions limiting the short-term exception, the *McClure* decision does not present a radical interpretation of the definition of a security. The court merely continued the trend of looking through the form to the substance of the securities laws and completed the last step in eliminating the mechanical short-term test.[19] The weakness of the decision is that it fails to provide adequate

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v. U.S., 206 F.2d 852 (9th Cir. 1953), *cert. denied,* 346 U.S. 923 (1954) (notes given in exchange for funds to be invested); 1 BROMBERG § 4.6, at 317. *Cf.* Bellah v. First Nat'l Bank, 495 F.2d 1109 (5th Cir. 1974) (short-term exception excluded a "commercial" note from federal regulation).

14. The commercial-investment dichotomy is discussed in Bellah v. First Nat'l Bank, 495 F.2d 1109 (5th Cir. 1974); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir. 1973); Lino v. City Inv. Co., 487 F.2d 689 (3d Cir. 1973); Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir. 1972); Davis v. Avco Corp., 371 F. Supp. 782 (N.D. Ohio 1974); SEC v. Thunderbird Valley, Inc., 356 F. Supp. 184 (D.S.D. 1973); Joseph v. Norman's Health Club, Inc., 336 F. Supp. 307 (E.D. Mo. 1971).

15. Some federal courts have literally applied the definition, Movielab, Inc. v. Berkey Photo, Inc., 452 F.2d 662 (2d Cir. 1971), *aff'g* 321 F. Supp. 806 (S.D.N.Y. 1970) (long-term commercial note was a security); Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989 (5th Cir. 1969) (loan participation agreement between banks).

16. Although the legislative histories of the Securities Act and the Exchange Act do not state specifically that Congress meant to exclude commercial notes from federal securities regulation, the congressional reports are replete with references to protecting "investors" and "investment securities." *See* S. REP. No. 792, 73d Cong., 2d Sess. 1 (1934); H.R. REP. No. 1383, 73d Cong., 2d Sess. 1 (1934); S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933); H. R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933).

17. McClure v. First Nat'l Bank, 497 F.2d 490, 495 (5th Cir. 1974).

18. *Id.* at 494-95.

19. *See* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967): "[I]n searching for the meaning and scope of the word 'security' in the [Exchange] Act, form should be

instruction on how to distinguish between an investment and a commercial note. The commercial-investment dichotomy is not a substitute test but merely a rather hazy line of demarcation. As the court in the instant case indicated, the distinction made in previous cases between commercial and investment notes is "not entirely clear because of the difficulty in expressing in judicial opinions the characteristics of those note transactions. . ." falling into each category.[20] The court did believe, however, that an adequate distinction had been drawn by the Seventh Circuit when it observed that "when a prospective borrower approaches a bank for a loan and gives his note in consideration for it, the bank has purchased commercial paper. But a person who seeks to invest his money and receives a note in return for it . . . has purchased a security investment."[21] In other words, the court felt that a security will be readily recognized, even though the courts cannot articulate the bases for the distinction.

Perhaps an all-encompassing test for the commercial-investment distinction would be too confining. Courts must be free to examine the context of each note in light of the general purpose of the securities laws in order to determine the note's investment or commercial nature. Nevertheless, it would have been helpful if the *McClure* decision had contained adequate guidelines, short of an actual test, to aid lawyers and judges in identifying those aspects of a transaction which would color the context "investment." The court mentioned only three factors indicating certain investment overtones. If notes are "offered to [a] class of investors," or are "acquired . . . for speculation or investment," or if the payor "obtain[s] investment assets, directly or indirectly, in exchange for [his] notes," then the transaction will most likely be deemed investment in nature, and the notes will be classified as securities.[22] As these indicia are not exclusive, courts must still look elsewhere for additional guidance before classifying the note.

One area of inquiry could be those cases which examine the characteristics of "investment contracts" as opposed to commercial transactions under the "security" definition.[23] An "investment con-

disregarded for substance and the emphasis should be on economic reality." Usually form is disregarded for substance in extending the coverage of the Act; however, precedent exists for likewise restricting the coverage. *See, e.g.*, Lino v. City Inv. Co., 487 F.2d 689 (3d Cir. 1973). *See also* 1 Loss 493.

20. 497 F.2d at 492.

21. Sanders v. John Nuveen & Co., 463 F.2d 1075, 1080 (7th Cir. 1972).

22. McClure v. First Nat'l Bank, 497 F.2d 490, 493-94 (5th Cir. 1974).

23. *See* Exchange Act § 3(a)(10): "The term 'security' means any. . .investment contract. . . ." 15 U.S.C. § 78c(a)(10). This approach of first literally applying the

tract" has been defined to exist when "a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[24] This test would be particularly helpful in detecting investment characteristics whenever the note secures the maker an interest in a common enterprise or whenever the payee expects return on the note only if the payor is successful in the purpose for which he borrowed the money. However, such test cannot function independent of other inquiries, for if literally applied it also embraces some purely commercial loans. For example, if an individual receives a note with a fixed interest rate from one who has borrowed money from others for the same purpose, it could be said that he is expecting profits on the note solely from the efforts of the note maker. Such a transaction, though fulfilling the requirement of the investment contract test, would most properly be classified as commercial.[25] The investment contract test is merely a tool to identify those aspects of a transaction which *tend* to make a note a security.

When making the commercial-investment distinction, courts may also look to other contexts in which notes were found to be investment in nature. For example, the investment character of a note has been detected when participation interests were sold in a loan,[26] or in a mortgage;[27] when the note was used as a subterfuge for an ordinary security;[28] when notes were offered to the general public;[29] or when the note was one in a series of notes given by a corporation seeking venture capital.[30] When a loan is involved, courts should

"security" definition and then examining the substance of the transaction through the use of the investment contract test has also recently been used by the Second Circuit. Forman v. Community Services, Inc., 500 F.2d 1246, 1253 (2d Cir. 1974).

24. SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946).

25. This type of transaction is commercial as it is "totally unrelated to the abuses involving 'trading for speculation or investment', which abuses Congress in 1934 sought to eliminate." McClure v. First Nat'l Bank, 352 F. Supp. 454, 458 (N.D. Tex. 1973).

26. Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989 (5th Cir. 1969)(loan participation agreement evidenced by notes between banks).

27. Farrell v. U.S., 321 F.2d 409 (9th Cir. 1963), *cert. denied*, 375 U.S. 992 (1964); Hall v. Security Planning Serv., Inc., 371 F. Supp. 7 (D. Ariz. 1974); SEC v. Los Angeles Trust Deed & Mortgage Exch., 186 F. Supp. 830 (S.D. Cal. 1960), *aff'd*, 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961); Securities Act Release No. 3892 (1958), in C.C.H. FEDERAL SECURITIES LAW REPORTER ¶ 76,559 (1958 Transfer Binder); Zabriskie v. Lewis, 507 F.2d 546, 551 (10th Cir. 1974).

28. Rekant v. Desser, 425 F.2d 872, 878 (5th Cir. 1970) (real estate corporation president given note by corporation for land which was used for a subdivision development).

29. *See, e.g.*, Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir. 1972).

30. Lino v. City Inv. Co., 487 F.2d 689, 691 (3d Cir. 1973) (dicta); SEC v. Fifth

examine the use of the proceeds:[31] If the proceeds are used to acquire consumer or commercial goods or services, the note will likely not be a security,[32] whereas if they are used for the "general financing" of a company, the cases indicate that the note will be declared investment in nature and thus a security.[33] The method of repayment may also indicate investment overtones. If repayment is a scheme contingent upon profits or is a percentage of production, a security is probably involved.[34] Giving the payee partial ownership or a percentage profit in addition to a fixed interest rate also suggests an investment. Finally, a comparison might be made between the amount of the note and the value of the collateral security.[35] If the latter is far greater, an investment is likely as it connotes an investment intent by the payor.

The Fifth Circuit's disregard of the mechanistic formula used in the Exchange Act is neither surprising nor undesirable. However, until the classifying process is further refined, uncertainty as to the applicability of the Act remains for persons dealing with notes.

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Avenue Coach Lines, 289 F. Supp. 3, 38 (S.D.N.Y. 1968) (dicta), *aff'd*, 435 F.2d 510 (2d Cir. 1970). *See also* UNIFORM COMMERCIAL CODE § 8-102(1)(a)(iii) (1972).

31. *See* Comment, 52 NEB. L. REV. 478, 510-12 (1973).

32. McClure v. First Nat'l Bank, 352 F. Supp. 454, 458 (N.D. Tex. 1973). The rationale is that consumer borrowers are protected under the Truth in Lending Act, 15 U.S.C. 1601 (1970), and business borrowers seeking funds to purchase business goods are merely exchanging the note as the *quid pro quo* for the funds. The lender is not investing in the note as he would be if the funds were used for the general financing of the business. *Contra*, City Nat'l Bank v. Vanderboom, 290 F. Supp. 592 (W.D. Ark. 1968) (proceeds of bank loan used to buy corporation stock did not make promissory note a security), *aff'd on other grounds*, 422 F.2d 221 (8th Cir. 1970).

33. MacAndrews & Forbes Co. v. American Barmag Corp., 339 F. Supp. 1401 (D.S.C. 1972) (note issued to purchase plant machinery); SEC v. Addison, 194 F. Supp. 709 (N.D. Tex. 1961) (notes sold to finance mining operations).

34. Schamber v. Aaberg, 186 F. Supp. 52 (D. Colo. 1960); Comment, 52 NEB. L. REV. 478, 510-12 (1972).

35. Comment, 52 NEB. L. REV. 478, 518 (1972).