"Notes" Are (Are Not?) Always Securities—A Review

By MARTIN LIPTON and GEORGE A. KATZ *
New York, New York

THE FEDERAL securities laws[1] each include "any note" within their definition of the term "security." To accommodate commercial paper, the 1933 Act exempts from the registration (but not the fraud) provisions notes used to finance current transactions[2] and the 1934 Act excludes from its definition of "security" "any note . . . which has a maturity at time of issuance of not exceeding nine months . . . ."[3]

Read literally, *any* "note" is therefore subject to the federal securities regulatory scheme, subject in the case of commercial paper to definitional exclusion or exemption from registration. However, a literal reading may be inappropriate and violative of legislative intent if it really means that every note of any denomination and no matter how originated, *e.g.*, in a personal loan transaction or in connection with a consumer installment purchase, is covered by the antifraud provisions of the federal securities laws. Several of the Circuit Courts of Appeals have recently been wrestling with the problem of whether a literal reading is appropriate from a legislative intent and policy standpoint.

Five appellate decisions in the last few years have focused squarely on the issue;[4] earlier opinions while touching on it, managed to skirt direct confrontation.[5] Despite language in these cases such as "*any* note, regardless

* Members of the New York Bar.

1. Securities Act of 1933, § 2(1), 15 U.S.C. § 77(b)(1) (1970); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1970); Trust Indenture Act of 1939, § 303(1), 15 U.S.C. § 77 ccc(1) (1970); Investment Company Act of 1940, § 2(a)(36), 15 U.S.C. § 80a-2(a)(36); Investment Advisers Act of 1940, § 202(a)(18), 15 U.S.C. § 80b-2(a)(18) (1970); Public Utility Holding Company Act of 1935, § 2(a)(16), 15 U.S.C. § 79b(a)(16) (1970).

2. 15 U.S.C. §§ 77c(a)(3), 77q(c) (1970). *See* SEC Securities Act Release No. 4412 (Sept. 20, 1961), setting forth the SEC's view that the exemptive provision of Securities Act § 3(a)(3) "applies only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public." *Cf.* §§ 216A and 301(n) of the American Law Institute Federal Securities Code, (Tent. Draft No. 1, 1972) defining "commercial paper" as involving instruments in denominations of at least $100,000 and maturing in not more than 9 months and like the present law, exempting "commercial paper" from the registration (but not the fraud) provisions of the securities law.

3. 15 U.S.C. § 78c(a)(10) (1970).

4. Lino v. City Inv. Co. [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,124 (3d Cir. 1973); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir.), *cert. denied*, 42 U.S.L.W. 3226 (1973); Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972); Movielab, Inc. v. Berkey Photo, Inc., 452 F.2d 662 (2d Cir. 1971); Rekant v. Dresser, 425 F.2d 872 (5th Cir. 1970).

5. *See e.g.*, Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989 (5th Cir. 1969) (dealing with the statutory language "any certificate of interest or participation

of its nature, terms or conditions, is fully subject to whatever antifraud provisions"[6] are contained in the federal securities laws, it is open to question whether the courts really mean just that. Indeed, in the latest of the Court of Appeals decisions, *Lino* v. *City Investing Co.*,[7] the Third Circuit held that "personal promissory notes issued by a private party" in partial payment for a franchise did not involve the "purchase" or "sale" of a security.[8]

The *Lino* court, like the others that considered the question, was mindful of the Supreme Court's direction that the antifraud statutes are remedial legislation and that the definition of "security" is to be given a broad reading.[9] Yet, it could not go along with the literal reading approach. Since *Lino* is the only Circuit Court case to involve a finding of the inapplicability of the securities laws where a note was directly involved, the analysis is best stated in the court's own words:

> All of the definitional sections involved in this case are introduced by the phrase "unless the context otherwise requires." The commercial context of this case requires a holding that the transaction did not involve a "purchase" of securities. These were personal promissory notes issued by a private party. There was no public offering of the notes, and the issuer was the person claiming to be defrauded. The notes were not procured for speculation or investment, and there is no indication that FI [defendant City Investing's subsidiary] was soliciting venture capital from Lino.
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> In no way could City Investing be said to have "purchased" Lino's notes for speculation or investment. City Investing was selling a certain contract right to Lino, not buying his security. It is just plain not common sense to describe the transaction as City Investing purchasing John Lino's security by paying him the right to operate one of its Franchise Sales Centers.
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> To accept Lino's argument would mean that any consumer who bought an article "on time" and issued a note would be able to sue in a federal court on the theory that the retailer had purchased his "security."[10]

The rationale of the Third Circuit can arguably be stated to have been

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in" a note, rather than a note itself); Llanos v. United States, 206 F.2d 852 (9th Cir. 1953) (dealing with the statutory language "evidence of indebtedness" rather than "note"). *See also,* SEC v. Fifth Ave. Coach Lines, Inc., 289 F.Supp. 3 (S.D.N.Y. 1968), *aff'd on other grounds,* 435 F.2d 510 (2d Cir. 1970) (considering the issue based on loan transactions rather than notes, albeit notes were involved).

6. Sanders v. John Nuveen & Co., 463 F.2d 1075, 1078 (7th Cir. 1972).

7. [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,124 (3d Cir. 1973).

8. *Id.* at 94,506-08.

9. *See, e.g.,* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); Tcherepnin v. Knight, 389 U.S. 332 (1967); SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

10. [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,124, at 94,507.

predicated on the non-existence of a "purchase" or "sale," rather than on a holding that the note involved was not a security. However, the court's references to the definitional sections indicates that it confronted squarely the literal reading issue and indeed ruled that every note is not a security and that it was merely drawing further comfort from the "purchase-sale" approach.

Lino was not a surprise. The Second Circuit, in *Movielab, Inc.* v. *Berkey Photo, Inc.*,[11] while holding that the $10,500,000 note issued by one public company to another public company, payable over a 20-year period, in exchange for the assets comprising a division of the payee's business was a "note" within the "security" definition, refused to follow the District Court's reluctant literal reading of the definition.[12] The Second Circuit in *Movielab* expressly declined to state that every note is a security and thereby face the spectre of an avalanche of federal litigation arising out of private note transactions—a consequence urged by the defendant as certain to befall the courts. Rather, the Second Circuit stated: "We need not deal with that hypothetical situation."[13] Thus, it left the "horror" or "floodgate" case for a future day. The *Lino* court obviously felt that it was faced with just such a case.

Sandwiched between *Lino* and *Movielab* were *Sanders* v. *John Nuveen & Co.*[14] and *Zeller* v. *Bogue Electric Manufacturing Corp.*[15] *Rekant* v. *Dresser*[16] was the first of the series. In each of these cases a Circuit Court found that the note involved was a security subject to the antifraud provisions.

In *Rekant* v. *Dresser*,[17] the Fifth Circuit upheld a complaint alleging a derivative action under Rule 10b-5 against the directors and officers of a corporation who fraudulently caused the corporation to purchase land from the president of the corporation at an inflated price where part of the payment for such land was the corporation's $782,674 unsecured note. Although the court used "literal reading" language in finding that the note was a security it also recognized that the "unless the context otherwise requires" prefatory language to the definition of "security" may in other instances be applicable. The holding that the purchase note was a security was further

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11. 452 F.2d 662 (2d Cir. 1971).

12. 321 F.Supp. 806 (S.D.N.Y. 1970). The District Court certified the question for interlocutory appeal.

13. 452 F.2d at 663. Nevertheless, most recently in 1050 Tenants Corp. v. Jakobson, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,177 at 94,766 (S.D.N.Y. 1973), Judge Stewart in holding that shares in a cooperative housing corporation were securities, drew an analogy to "notes" and the "literal reading" language in Judge Mansfeld's District Court opinion in *Movielab*. The Court of Appeals' more restricted treatment of the issue in *Movielab* was given no weight; nor was the Second Circuit's opinion in Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir.) *cert. denied*, 42 U.S.L.W. 3226 (1973) cited. Reliance was also placed, as is the case in most instances where notes are held to be securities, on the *Lehigh Valley* and *Llanos* cases which, as heretofore noted, did not directly involve notes. *See* note 5 *supra*.

14. 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972).

15. 476 F.2d 795 (2d Cir.), *cert. denied*, 42 U.S.L.W. 3226 (1973).

16. 425 F.2d 872 (5th Cir. 1970).

17. *Id.*

justified by the court because the corporation chose "to pay for the land by the issuance of its note as opposed to the issuance of some other form of security"[18] and it should not thereby avoid the regulatory scheme envisioned by the securities laws.

In *Sanders,* the Seventh Circuit found that short term commercial paper offered and sold to the general public was neither an exempt note under the Securities Act of 1933[19] nor an excluded note under the Securities Exchange Act of 1934.[20] The court did not concentrate its analysis on whether or not the notes involved were or were not securities. Rather, its analysis focused on whether an exemption or exclusion existed because of the less than nine months maturity of the paper. The court categorically stated that "*any* note" is subject to the antifraud provisions unless specifically exempted or excluded. In holding that the particular notes involved were not entitled to the short term note exclusion, the court emphasized that they were sold to the general public[21] rather than in the usual institutional commercial paper market. In bottoming its rationale for non-exclusion on the nature and purpose of the purchaser,[22] the court found that the notes involved were not "commercial paper in the usual sense" but rather "a security investment" which Congress did not intend to be subject to the exclusion for short term paper notwithstanding that a literal reading of the definition of "security" shows that "any note" of less than nine months maturity is to be excluded. Thus, in effect, a literal reading test was employed for definitional inclusion, but a policy and intent approach was utilized for the purpose of definitional exclusion. It is noteworthy that *Movielab* was not cited by the Seventh Circuit in *Sanders.*

In *Zeller,* a derivative action under Rule 10b-5, the Second Circuit—which two years earlier had decided *Movielab* and now had the Seventh Circuit's views in *Sanders*—ruled that a subsidiary which as a result of upstream loans acquired its parent's demand promissory note had purchased a security. Judge Friendly easily disposed of the exclusion problem, notwithstanding the demand nature of the note, since the controlling parent corporation could prevent demand and the note was in fact outstanding for more than ten months. In so holding, Judge Friendly noted agreement with the Seventh Circuit in *Sanders* "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."[23] However, and without otherwise commenting on *Sanders,* but clearly picking up the thread initiated in *Movielab,* he then stated:

> It does not follow, however, that every transaction within the introductory clause of § 10, which involves promissory notes, whether of

18. *Id.* at 878.
19. 15 U.S.C. §§ 77a-aa (1970).
20. 15 U.S.C. §§ 78a-jj (1970).
21. There were 42 purchasers, 40 of whom invested from $3,000 to $100,000, with the other 2 investing $150,000 and $205,000.
22. 463 F.2d at 1079-80.
23. 467 F.2d at 800.

> less or more than nine months maturity, is within Rule 10b-5. The Act is for the protection of *investors,* and its provisions must be read accordingly.[24]

Notwithstanding some strong language to the contrary contained in *Sanders,* the inescapable conclusion from the five Court of Appeals cases is that not every note is a security, that the nature of the note as well as the transaction which is its source will be looked at and a determination made in the context of usual commercial practice as to whether an investment in—or the "purchase" and "sale" of—a security was contemplated. This is clearly the holding in *Lino* and the purport of the Second Circuit opinions—if not the Seventh Circuit.

The District Court decisions have utilized the same analytical approaches adopted by the higher courts. And, as with the higher courts, there are numerous conflicts. Thus, cases are plentiful for the proposition that all notes—or even instruments equated to notes—are securities: two cases involved notes claimed to have been given merely for a loan, but which were found instead to have been given by many investors for interests in commodities or mining operations;[25] two squarely held that promissory notes given for personal loans are securities;[26] an $11,000 refundable deposit given to a broker in connection with an application for a construction loan was deemed the equivalent of a note;[27] as was a bill of exchange given for the purchase of machinery.[28]

On the other hand it has been held by District Courts that promissory notes given for purely personal loans are not securities;[29] nor are notes given in payment for lifetime membership in a health club.[30]

Analysis and synthesis of the cases does not result in a conclusion that all

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24. *Id.* (emphasis supplied).

25. Anderson v. Francis I. DuPont, 291 F.Supp. 705 (D.Minn. 1968) (the court here also found that the scheme involved the sale of an "investment contract"); SEC v. Addison, 194 F.Supp. 709, 715 (N.D. Tex. 1961).

26. Prentice v. Hsu, 280 F.Supp. 384 (S.D.N.Y. 1968); Olympic Capital Corp. v. Newman, 276 F.Supp. 646, 653 (C.D. Cal. 1967) (that such notes were securities, however, was "not questioned by any party herein").

27. Whitlow & Associates, Ltd. v. Intermountain Brokers, Inc., 252 F.Supp. 943, 947-48 (D.Hawaii 1966).

28. MacAndrews & Forbes Co. v. American Barmag Corp., 339 F.Supp. 1401 (D.S.C. 1972) (relying upon the *Llanos* and *Lehigh Valley* cases and the District Court opinion in *Movielab*).

29. McClure v. First Nat'l Bank, 352 F.Supp. 454 (N.D.Tex. 1973). *See also* Beury v. Beury, 127 F.Supp. 786 (S.D.W.Va. 1954), *appeal dismissed,* 222 F.2d 464 (4th Cir. 1955) ("$70,000 loan cannot be considered a transaction in securities"; not clear whether a note was involved or not); SEC v. Fifth Ave. Coach Lines, Inc., 289 F.Supp. 3 (S.D.N.Y. 1968), *aff'd on other grounds,* 435 F.2d 510 (2d Cir. 1970) ("One does not normally speak of the 'purchase' or 'sale' of a loan whether or not it is evidenced by a note.")

30. Joseph v. Norman's Health Club, 336 F.Supp. 307 (E.D.Mo. 1971) (opinion also questions whether issuance of such a note is a "sale"); *But cf.* MacAndrews & Forbes Co. v. American Barmag Corp., 339 F.Supp. 1401 (D.S.C. 1972), (holding issuance can be equated to a "sale").

may necessarily agree upon. There is, of course, the strong and still growing line of cases regularly cited for the proposition that any note is a security. Despite the frequent assertion that any note is a security, *Movielab, Zeller* and *Lino* teach that this is not always so. When then, will a note be deemed a security and when will it not. In *Lino* the court pointed out that the parties recognized different possible conclusions and the existence of a line of demarcation, each however contending that it fell on a different side of the line.[31] Judge Woodward, in the *McClure* v. *First Nat'l Bank*[32] attempted to locate the line. He said—and the citation to his opinion by the *Lino* court indicates adoption of his approach—that ordinary and conventional commercial notes, arising out of personal loan transactions, or given for the purchase of property that would ordinarily be paid for in cash or on credit are not securities within the framework of the federal securities laws. Both *Lino* and *McClure* also emphasize that neither the ordinary loan nor the consumer purchase transaction was intended to be covered by the federal securities laws, which were designed to curb abuses in the investment process and business. This approach explains most of the cases; although some, such as *MacAndrew & Forbes Co.* v. *American Barmag Corp.*[33] and *Whitlow & Associates, Ltd.* v. *Intermountain Brokers, Inc.*[34] do not fit into the pattern and must be deemed contrary to the trend away from the literal reading, any note is a security, approach.

Not every note is a security. The commercial context of the underlying transaction has to be evaluated. Notes issued for personal loans and consumer installment purchases are not securities. Notes that are issued for investments and business acquisitions as well as commercial paper sold outside the normal institutional market are securities. The middle ground has been narrowed, but will still from time to time create a problem. The courts have seen the impact of the open "floodgates" in other areas and should pay heed to the legislative intent and policy considerations discussed above. The federal securities laws are not the appropriate vehicle for consumer protection on installment sales.

31. *See* comment to § 201(a) of the American Law Institute Federal Securities Code, (Tent. Draft No. 1, 1972) recognizing the difficulty in establishing "precise statutory solution" through definitions and thereby continuing the "unless the context otherwise requires" approach.

32. 352 F.Supp. 454 (N.D.Tex. 1973).

33. 339 F.Supp. 1401 (D.S.C. 1972).

34. 252 F.Supp. 943 (D.Hawaii 1966).