"Notes" Are Not Always Securities

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SHORTLY AFTER the publication of our review of the subject in the April 1974 issue of *The Business Lawyer*[1] several decisions considering the question of "notes" as "securities" were reported. These decisions, notably those in the Fifth Circuit, further support the conclusion that not every note is a security. The literal reading approach has been rejected. The short-term note exception has been abandoned. An economic realities approach has been adopted. A note (even a short-term note) issued in connection with an *investment* type transaction is a security. A note issued in a *commercial* type transaction (at least in the Fifth Circuit, even a long-term note) is not a security. The focus is now on the nature of the transaction giving rise to the issuance of the note.

While the investment-commercial dichotomy that has evolved from the recent cases is designed to fulfill the basic purposes of the securities laws, it is more easily stated than applied. A review of these cases points up the difficulties.

During June and July, 1974, the Fifth Circuit rendered three well-reasoned opinions on the subject. It held first, in *Bellah* v. *First National Bank*,[2] that a six-month promissory note, collateralized by a deed of trust, renewing prior bank loans to a rancher to finance his livestock business, was commercial rather than investment in nature, and therefore not a security. The court rejected the literal reading approach, refusing to "ritualistically apply" the "seemingly absolute mandate" of the definitional section of the 1934 Act. In so doing it adopted the reasoning in *Lino* v. *City Investing Co.*,[3] and *Sanders* v. *John Nuveen & Co.*,[4] and concluded that "notes issued in the context of a commercial loan transaction fall beyond the purview of the [1934] Act."

One month later, Judge Gewin, who wrote the opinion in *Bellah*, writing for another panel of the court in *SEC* v. *Continental Commodities Corp.*,[5] held that notes maturing in less than nine months, issued by a broker to its customers as partial reimbursement for losses sustained by them in connection with discretionary trading accounts and commodity options, were non-exempt securities, since the context of their issuance was investment rather

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1. Lipton & Katz, *"Notes" Are (Are Not?) Always Securities—A Review*, 29 Bus. Law. 861 (1974).
2. 495 F.2d 1109 (5th Cir. 1974).
3. 487 F.2d 689 (3rd Cir. 1973).
4. 463 F.2d 1075, 1080 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972).
5. 497 F.2d 516 (5th Cir. 1974).

than commercial. That the notes were short term—less than nine months—was held not to be dispositive. As in *Sanders* the short-term note exception was deemed to apply only to commercial and not investment paper.[6] In determining that the notes at issue were investment rather than commercial the court found a close analogy to *Zeller* v. *Bogue Elec. Mfg. Corp.*[7] where the notes were issued to rejuvenate and not to liquidate the issuer, and the noteholders stood to benefit from the issuer's continued vitality. By way of contrast the noteholders in *Lino* and *Bellah* received no independent benefit, noted the court, since they were not investing in the issuer's franchise (in *Lino*) or cow business (in *Bellah*) in the hope of profiting from the success of the business. In those cases the activity of the lender was considered to be more akin to financing a venture—a commercial effort—rather than investing in the venture itself. While the courts in *Continental Commodities* and *Zeller* did not mention the "risk capital" approach to defining an investment contract, the analogy is striking—in both cases the financial condition of the debtor was such that, in economic reality, the "notes" were risk capital of the equity type rather than the debt type.[8]

With *Bellah* and *Continental Commodities* behind them, another panel of the Fifth Circuit[9] affirmed Judge Woodward's holding in *McClure* v. *First National Bank*[10] that a $200,000 bank loan to a two-shareholder corporation, evidenced by the corporation's one-year promissory note, secured by a pledge of stock, was a commercial transaction not covered by the federal securities laws. In reaching this conclusion the court noted that the bank loan was to enable the borrower to pay off debts rather than to acquire investment assets and that only the bank and the borrower were involved, the notes being neither offered publicly to investors through a broker or acquired by the bank for speculation or investment, as in *Sanders*.

In holding that a *commercial* note of a longer duration than nine months is not a security, the court in *McClure* was fully cognizant that it was writing the short-term exception out of the law. It summarized: "On one hand, the Act covers all *investment* notes, no matter how short their maturity, because they are not encompassed by the 'any note' language of the exemption. On the other hand, the Act does not cover any *commercial* notes, no matter how

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6. *See* U.S. v. Rachal, 473 F.2d 1338, 1343 (5th Cir.), *cert. denied,* 412 U.S. 927 (1973.)

7. 476 F.2d 795 (2d Cir.), *cert. denied,* 414 U.S. 908 (1973).

8. The leading case on the "risk capital" approach to the definition of security is Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906 (1961). *See also* Hawaii v. Hawaii Market Center, Inc., 52 Hawaii 642, 485 P.2d 105 (1971).

9. McClure v. First National Bank, 497 F.2d 490 (5th Cir. 1974). In the three cases, seven of the Fifth Circuit judges participated in the holdings, all of which were unanimous.

10. 352 F. Supp. 454 (N.D.Tex. 1973).

long their maturity, because they fall outside the 'any note' definition of a security."[11]

The latest decision is *Zabriskie* v. *Lewis*,[12] in which the Tenth Circuit joined the circuits that have adopted the investment-commercial test. In *Zabriskie* the plaintiff was an unsophisticated person who sought assistance in finding "investments" and was sold short-term notes with a promised 120 percent return, the proceeds of which were to be used for the promotion of a start-up corporation. While recognizing that the distinction between investment notes and commercial notes based on the use of proceeds is often difficult, the court holds that where the "transaction is one of the kind in which stock often is actually given"[13]—such as the promotion of a start-up corporation—the transaction is clearly investment and not commercial. (This "stock" analogy is but a variation of the "risk capital" analogy hinted at in *Continental Commodities* and *Zeller*.) The *Zabriskie* court also recognized the distinction between the unsophisticated lender-buyer and the unsophisticated borrower-issuer, quoting with approval from *Sanders:*

> 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

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11. 497 F.2d at 494-495. *See also* Avenue State Bank v. Tourtelot, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,859 (N.D.Ill. 1974). *Compare* Alberto-Culver Co. v. Scherk, 484 F.2d 611, 615 (7th Cir. 1973), rev'd on other grounds, 414 U.S. 1156, 94 S.Ct. 2449 (1974); Movielab, Inc. v. Berkey Photo, Inc., 452 F.2d 662 (2d Cir. 1971); Rekant v. Desser, 425 F.2d 872 (5th Cir. 1970). The literal reading or plain meaning approach, rejected in McClure, was followed, however, when the instrument was "stock" rather than a "note." In Forman v. Community Services, Inc., [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,594 (2nd Cir. 1974), *pet. for cert. filed* Aug. 22, 1974. *See* 1050 Tenants Corp. v. Jakobson, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,702 (2d Cir. 1974), the Second Circuit ruled that shares of stock in a nonprofit residential co-op are not merely incidental to the basic apartment rental transaction and relying on the literal reading approach, held such shares to be securities. In Occidental Life Ins. Co. v. Pat Ryan & Assoc., Inc., 496 F.2d 1255 (4th Cir., *cert. denied* ___ U.S. ___ (1974) the Fourth Circuit refused to look to the economic realities and rejected an argument that the sale of all of the stock of a wholly-owned subsidiary was merely a means of transferring the subsidiary's assets and therefore a purchase of a business rather than an investment in stock; the court reasoned that in determining applicability of the securities laws it is irrelevant that the transaction could have been structured as an asset deal—if "stock" was involved, the federal securities laws apply. However, the courts have developed a resilient and functional approach for determining whether a given transaction is an "investment contract" within the definition of "security." *See e.g.,* Safeway Portland Employees' Federal Credit Union v. C. H. Wagner, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,763 (9th Cir. 1974); El Khadem v. Equity Securities Corp., 494 F.2d 1224 (9th Cir.), *cert. denied* ___ U.S. ___ (1974), SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied* 414 U.S. 821 (1973).

12. [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,902 (10th Cir. 1974).

13. *Id.* at p. 97,066.

> in return for it has not purchased commercial paper in the usual sense. He has purchased a security investment.[14]

The *Zabriskie* opinion summarizes the rationale of the investment-commercial test:

> This test is based on [1] the purpose of the Act to protect investors, [2] the "unless the context otherwise requires" language, and [3] the practical considerations of subjecting commercial notes to the registration provisions of the Securities Act as well as [4] fear of the resulting litigation flooding the federal courts if commercial notes were included. The test accords with the exalting of economic reality over form . . . and seeks to protect investors. . . .[15]

It is not always easy to determine whether a loan is a commercial or investment type transaction. If the nine-month limitation is no longer the determining factor, is any period either a determinant or a significant factor? How, for example, is the bank term loan or the institutional note private placement to be treated? Is subordination or collateral a factor? What significance should be given to renewal rights—or renewals as a matter of practice between the parties? Is the purpose of the loan significant? Is a note "commercial" if the proceeds are to be used for working capital, but "investment" if the proceeds are to be used for plant, equipment or other "fixed" assets or for the acquisition of a company? The analogy between the use-of-proceeds test for deciding the investment-commercial question to the "current transaction" requirement under the Securities Act of 1933 for exempt commercial paper is apparent.[16]

Recent district court cases considering whether notes are securities have picked up the investment-commercial approach. At least where the purchaser is a bank or other institutional or professional investor the courts seem to be embarking on a case-by-case application of the investment-commercial dichotomy predicated on an analysis of purpose or use of proceeds. Where the *purchaser* is unsophisticated, the courts have indicated that no matter whether long-term or short-term the note will be deemed a security. Where the *issuer* is unsophisticated, the courts have developed a relationship test: If the note was issued to pay for an investment then it is a security, but if the

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14. Sanders v. John Nuveen & Co., 463 F.2d 1075, 1080.

15. [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,902 at p. 97,066.

16. Securities Act Release No. 4412 (Sept. 20, 1961). *See also* Spring Mills, Inc., [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,217; Gulf Mortgage & Realty Investments, [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,008; Real-Tex Enterprises, Inc., [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,813; First Union Real Estate Equity and Mortgage Investments, [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,837; Cabot, Cabot & Forbes Land Trust, [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,677; First Chicago Corp., [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,010.

note was issued to pay for personal property or a personal loan it is not a security.

In *Welch Foods Inc.* v. *Goldman, Sachs & Co.*[17] the court was presented with the question whether the almost $100,000,000 of commercial paper issued by Penn Central and sold in the usual manner by Wall Street's leading commercial paper dealer was entitled to the commercial paper—short-term—exemption in Section 3(a)(10) of the 1934 Act. Relying on *Sanders* and *Zeller* the court held the Penn Central commercial paper not exempt and therefore a security. Following the four criteria used by the Securities and Exchange Commission for applying the 1933 Act commercial paper exemption[18]—relied on in *Sanders* and *Zeller*—the court found that the Penn Central commercial paper was:

> (1) not prime quality, even though so rated by Dun & Bradstreet, on the ground that Goldman, Sachs knew that Penn Central was in financial difficulty;
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> (2) not within the category of commercial paper not ordinarily purchased by the general public because Goldman, Sachs knew that bank purchasers were reselling to individuals and other nonprofessionals in the commercial paper market (the court viewed the three large companies that were the plaintiffs as "general public" because as investors in commercial paper they had no greater expertise than the general public);
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> (3) not issued for current operations on the ground that the proceeds were used for past capital expenditures and to meet matured debt; and
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> (4) not eligible for discounting by Federal Reserve Banks, again because not issued to finance current transactions.

Welch Foods is clearly the epitome of the economic realities test evolved by the courts.

In *United States* v. *Koenig*,[19] the court in dictum considered both a $4,000,000 commercial-bank "bridge" loan and the institutional private placement in the same amount being "bridged" as commercial and hence not securities. The court, purporting to follow those "note" cases "which have recognized context-over-text and have given effect to the provision 'unless the context otherwise requires' " felt that the loans were commercial, and not investment, such as "in situations where other securities would otherwise be appropriate." No reasoning was offered, however, for the conclusion that the loans were commercial.

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17. [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,806 (S.D.N.Y. 1974).

18. The Penn Central commercial paper was exempt from the registration requirements of the 1933 Act under Section 3(a)(6) because its issuance was approved by the Interstate Commerce Commission.

19. [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,765 (S.D.N.Y. 1974).

Davis v. *Avco Corp.*[20] involved a complaint bottomed on notes issued in connection with plaintiff's investment in the Glenn W. Turner Enterprises "Dare to Be Great" pyramid scheme—itself an "investment contract." In denying a motion to dismiss, the court held that the notes were not issued in a pure consumer financing setting, but, as a matter of economic reality, as part of an investment transaction where the need for the protection of the anti-fraud provisions of the securities laws was called for.

Crowell v. *Pittsburgh & Lake Erie R.R. Co.*[21] involved short-term notes representing loans by a controlled subsidiary to Penn Central Transportation Company, its publicly held parent company. The loans were a diversion to the parent of the subsidiary's excess cash, previously invested in short-term commercial paper. The loans were initially evidenced by receipts, and later by six-month notes. Relying upon *Zeller* and *Movielab, Inc.* v. *Berkey Photo, Inc.*,[22] the court sustained the complaint holding that such short-term notes, "where repayment in accordance with the stated terms is not intended" are securities. Short-term notes evidencing parent-subsidiary loans that are intended to be rolled over fall on the investment side of line.

In *Ingenito* v. *Bermec Corp.*,[23] extension notes issued by herdowners in exchange for notes originally issued by them in connection with a cattle-tax-shelter program (which program the court assumed to be an investment contract) were held to be securities. In reaching its conclusion that the exchange of notes was an exchange of securities, the court relied both on a literal reading approach and the relationship to the underlying tax-shelter transaction.

In *Rosen* v. *Dick*,[24] the court rejected the literal reading approach and adopted the commercial-investment dichotomy. A buyer issued its stock to purchase a business. The "security" in question was a $4,500,000 note given by the seller of the business in settlement of fraud claims by the buyer. The note was deemed commercial, it having been "given in consideration for [the buyer] giving up its right to sue for any fraud in connection with the . . . acquisition." Except that the plaintiff here was a sophisticated corporate acquirer, this holding is inconsistent with *Continental Commodities* where the "note" transaction was also subsequent to an earlier "securities" transaction between the parties and grew out of an infirmity in the original transaction. *Rosen* v. *Dick* follows *McClure* in holding that the mere pledge of stock as collateral for a note does not convert a commercial transaction into an investment transaction.

The investment-commercial dichotomy is basically the right approach to the question of whether a note is a security, and the earlier cases holding that

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20. 371 F. Supp. 782 (N.D. Ohio 1974). *See also* Barthe v. Rizzo, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,741 (S.D.N.Y. 1974).
21. 373 F. Supp. 1303 (E.D.Pa. 1974).
22. 452 F.2d 662 (2d Cir. 1971).
23. 376 F. Supp. 1154, 1178-1180 (S.D.N.Y. 1974).
24. [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,786 (S.D.N.Y. 1974).

notes issued for personal loans[25] or the purchase of personal property[26] were securities should not be followed.[27] Like notes issued for franchises, notes issued for personal loans and the purchase of personal property usually involve unsophisticated persons as issuers rather than as purchasers. In the personal loan or personal property situation there is no related investment transaction. In the franchise situation the note is issued in connection with an investment by the issuer in the franchise. If the franchise is considered a security (investment contract), such as in *Davis,* the notes issued in payment therefor will be deemed investment in nature—not on the rationale of *Sanders* where the unsophisticated person was the purchaser of the notes, but on the rationale of a nexus to an investment transaction—the franchise purchase—by a person who needs the protection of the securities laws. On the other hand, as in *Lino,* if the franchise is not an investment contract but a real franchise, there is no connection to an investment transaction, and the note issued in payment for the franchise will be treated as commercial—as the equivalent of a loan to purchase personal property. Thus, even if the issuer is unsophisticated and needs protection, as may be the case in many personal loan and personal property note cases, the securities laws are not, and should not be, stretched to cover the situation in the absence of an investment nexus. Only where there is a related investment transaction does this type of note issuance become a security transaction.

While the Fifth Circuit decisions in *Bellah* and *McClure* might be said to establish that all bank loans are commercial transactions and therefore not securities, and that this result is consistent with the purpose of the securities laws to protect those who need the protection, this will undoubtedly prove to be too broad an exception. Aside from the policy argument that even sophisticated investors are entitled to the securities law protections against fraud, there is the difficulty of determining which lenders are sophisticated. However, the purpose test also doesn't hold much appeal as the basis on which to decide whether a bank loan is a security. It is difficult to distinguish between a bank loan for working capital purposes and one to finance fixed assets or a business acquisition. As in *Movielab,* the courts will find it difficult, if not impossible, to hold that twenty-year notes, no matter how sophisticated the purchaser and no matter what the use of the proceeds, are not securities. Bridge loans, construction loans, and other forms of interim financing present similar questions. It is hard to distinguish between a bridge loan to be taken out by a public offering of stock and the same bridge loan to be taken out by a five-year bank term loan.

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25. *E.g.,* Prentice v. Hsu, 280 F. Supp. 384 (S.D.N.Y. 1968).

26. *E.g.,* MacAndrews & Forbes Co. v. American Barmag Corp., 339 F. Supp. 1401 (D.S.C. 1972).

27. "Clearly, if the proceeds of a note are used to purchase consumer goods or services, the note has a commercial character." Zabriskie v. Lewis, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,902 at p. 97,066.

The investment-commercial test has the advantages of flexibility. It can be used to exclude most transactions which need not be encumbered with the protections of the securities laws, and yet be held in reserve to provide fraud protection where needed. The only other alternative would be to apply the investment-commercial test to short-term notes so as to close the loophole for commercial paper sold in small denominations to unsophisticated investors, as in *Sanders,* but not apply the test to long-term notes. Thus all notes over nine months, without regard to context or purpose, would be securities. This would provide certainty and in most cases fulfill the purpose of the securities laws. Its major defect would be that it would extend the securities laws to the one-year personal loan and the three-year car loan. To avoid this absurd result it is preferable to accept the infirmities of the investment-commercial test applied to all notes, whatever their term.

APPENDIX

Cases Considering Whether "Notes" Were "Securities"

I. "Notes" held to be "securities":

Zabriskie v. Lewis, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,902 (10th Cir. 1974); SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir.), *cert. denied,* 414 U.S. 908 (1973); U.S. v. Rachal, 473 F.2d 1338, 1343 (5th Cir.), *cert. denied,* 412 U.S. 927 (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 (2nd Cir. 1971); Rachal v. Hill, 435 F.2d 59, 65 (5th Cir. 1970), *cert. denied, sub. nom.* Hill v. Rachal, 403 U.S. 904 (1971); Rekant v. Dresser, 425 F.2d 872 (5th Cir. 1970); Farrell v. U.S., 321 F.2d 409, 416 (9th Cir. 1963); Welch Foods, Inc. v. Goldman, Sachs & Co., [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,806 (S.D.N.Y. 1974); U.S. v. Koenig, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,765 (S.D.N.Y. 1974); Barthe v. Rizzo, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,741 (S.D.N.Y. 1974); Ingenito v. Bermec Corp., 376 F. Supp. 1154, 1178-80 (S.D.N.Y. 1974); Crowell v. The Pittsburgh & Lake Erie R.R. Co., 373 F. Supp. 1303 (E.D.Pa. 1974); Davis v. Avco Corp., 371 F. Supp. 782 (N.D. Ohio 1974); Hall v. Security Planning Service, Inc., 371 F. Supp. 7 (D. Ariz. 1974); MacAndrews & Forbes Co. v. American Barmag Corp., 339 F. Supp. 1401 (D.S.C. 1972); Investment Properties Int'l, Ltd. v. I.O.S., Ltd., [1970–1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,011 (S.D.N.Y. 1971); Young v. Seaboard Corporation, 360 F. Supp. 490, 495-6 (D. Utah 1973); SEC v. Thunderbird Valley, Inc., 356 F. Supp. 184 (D.S.D. 1973); U.S. v. Hill, 298 F. Supp. 1221 (D. Conn. 1969); Anderson v. Francis I. DuPont, 291 F. Supp. 705 (D. Minn. 1968); Prentice v. Hsu, 280 F. Supp. 384 (S.D.N.Y. 1968); Olympic Capital Corp. v. New-

man, 276 F. Supp. 646, 653 (C.D. Cal. 1967); Whitlow & Associates, Ltd. v. Intermountain Brokers, Inc., 252 F. Supp. 943, 947-48 (D. Hawaii 1966); SEC v. Gulf Intercontinental Fin. Corp., 223 F. Supp. 987, 994 (S.D. Fla. 1963); SEC v. Addison, 194 F. Supp. 709, 721 (N.D. Texas 1961); SEC v. Los Angeles Trust Deed & Mortgage Exchange, 186 F. Supp. 830 (S.D. Cal.), *mod. on other grounds,* 285 F.2d 162 (1960), *cert. denied* 366 U.S. 919 (1961); SEC v. Vanco, Inc., 166 F. Supp. 422 (D.N.J. 1958), *aff'd,* 283 F.2d 304 (3d Cir. 1960). *See also,* Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989 (5th Cir. 1969); Llanos v. U.S., 206 F.2d 852 (9th Cir. 1953), *cert. denied,* 346 U.S. 923 (1954); U.S. v. Monjar, 147 F.2d 916,920 (3d Cir. 1944), *cert. denied,* 325 U.S. 859 (1945).

II. "Notes" held not to be "securities":

McClure v. First National Bank, 497 F.2d 490 (5th Cir. 1974); Bellah v. First National Bank, 495 F.2d 1109 (5th Cir. 1974); Lino v. City Inv. Co., 487 F.2d 689 (3rd Cir. 1973); Rosen v. Dick, [Current Binder] CCH Fed. Sec. L. Rep. ¶94,786 (S.D.N.Y. 1974); Avenue State Bank v. Tourtelot, [Current Binder] CCH Fed. Sec. L. Rep. ¶94,859 (N.D. Ill. 1974); Joseph v. Norman's Health Club, 336 F. Supp. 307 (E.D. Mo. 1971); Beury v. Beury, 127 F. Supp. 786 (S.D.W. Va. 1954), *appeal dismissed,* 222 F.2d 464 (4th Cir. 1955). *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).