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Commercial Notes and Definition of “Security” under Securities Exchange Act of 1934: A Note Is a Note Is a Note?

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**COMMERCIAL NOTES AND DEFINITION OF 'SECURITY'
UNDER SECURITIES EXCHANGE ACT OF
1934: A NOTE IS A NOTE
IS A NOTE?**

EDITOR'S NOTE—After this comment was set in type, the United States Court of Appeals for the Third Circuit in *Lino v. City Investing Co.*, [1973 Current] CCH FED. SEC. L. REP. ¶ 94,124 (3d Cir. Aug. 20, 1973), reversed the district court's holding, criticized in this article, that the promissory notes involved were securities. The primary basis for the Third Circuit's decision was that the commercial context of the transaction in which the notes were given required a holding that the notes were not securities. In this regard, and in several finer details of the opinion, the views of the Third Circuit coincide with those of the author expressed in this comment. There remains, however, a split among the federal courts on the issue, which perhaps indicates its ripeness for definitive Supreme Court review.

* * *

I. INTRODUCTION

The relative ease with which one may recover for a violation of SEC Rule 10b-5¹ has led prospective plaintiffs to seek redress in

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1. 17 C.F.R. § 240.10b-5 (1972) [hereinafter cited as Rule 10b-5], promulgated under the Securities Exchange Act of 1934 [hereinafter cited as the 1934 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,

federal forums² even though their claims do not involve instruments which fall within the everyday conception of securities. Since 1970 five cases³ have posed to the federal courts an issue never before examined in the context presented: Whether the maker of a promissory note given in an ordinary commercial context for a purpose other than the general financing of its business may sue in the federal courts for alleged fraud on the part of the payee. Stated differently, the question is whether the taking of such a note by the payee constitutes the "purchase"⁴ of a "secu-

(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 upon any person,

in connection with the purchase or sale of any security.

"It is now established that a private right of action is implied under § 10(b)." Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971). The truth of this statement was virtually unquestioned even before that Supreme Court pronouncement. See 6 L. LOSS, SECURITIES REGULATION 3869-73 (2d ed. 1961, Supp. 1969) [hereinafter cited as LOSS]; 1 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5 § 2.4(1) (1967), as supplemented [hereinafter cited as BROMBERG]. Furthermore, Rule 10b-5 is the broadest of the remedial fraud provisions in the federal securities law arsenal. 1 BROMBERG § 2.3(800). It is generally easier to recover for securities fraud under the Rule than under state law. See 1 BROMBERG § 2.7 (1)-(2); Part IIIA1. *infra*.

2. The 1934 Act, § 27, 15 U.S.C. § 78aa (1970), confers upon the federal courts exclusive jurisdiction over suits arising from the Act. If the disputes described in this article are cognizable in the federal courts, they would fall solely within the province of the 1934 Act with its exclusive federal jurisdiction. See note 4 *infra*.
3. McClure v. First Nat'l Bank, 352 F. Supp. 454 (N.D. Tex. 1973); Lino v. City Investing Co., Civil No. 1439-71 (D.N.J. April 25, 1972), appeal docketed, Nos. 72-1672, 72-1673, 3d Cir., Aug. 7, 1972; MacAndrews & Forbes Co. v. American Barmag Corp., 339 F. Supp. 1401 (D.S.C. 1972); Joseph v. Norman's Health Club, Inc., 336 F. Supp. 307 (E.D. Mo. 1971); Movielab, Inc. v. Berkey Photo, Inc., 321 F. Supp. 806 (S.D.N.Y. 1970), *aff'd*, 452 F.2d 662 (2d Cir. 1971). All five cases presented claims for relief under Rule 10b-5; the plaintiffs in *Lino*, *MacAndrews* and *Joseph* also asserted additional grounds for relief.
4. The question must be phrased in terms of a fraudulent "purchase" rather than in terms of a fraudulent "sale" for both conceptual and statutory reasons. Conceptually, the word "purchase" rather than "sale" is necessary because it is the maker of the note who is asserting that he, as the "seller" of a "security," was defrauded by the payee, as the "purchaser" of a "security." But the distinction is

ity"⁵ within the meaning of the Securities Exchange Act of 1934.⁶

If the answer to these questions is affirmative, then, as stated in *Movielab, Inc. v. Berkey Photo, Inc.*⁷ by the first federal court to

more than conceptually significant in view of the statutory scheme of the federal securities laws. The Securities Act of 1933 [hereinafter cited as the 1933 Act], 15 U.S.C. §§ 77a-77aa (1970), prohibits only fraud on the part of sellers. Section 11(a) of the 1933 Act, 15 U.S.C. § 77k(a) (1970), imposes civil liability on certain persons involved in the preparation of a registration statement; such persons are necessarily on the "seller's side" of the picture. Similarly, sections 12(2) and 17(a) of the 1933 Act are limited to fraud on the part of offerors or sellers of securities. 15 U.S.C. § 77l(2) (1970) ("Any person who . . . offers or sells a security"); 15 U.S.C. § 77q(a) (1970) ("any person in the offer or sale of any security"). In contrast, the 1934 Act, § 10(b) and Rule 10b-5 promulgated thereunder, prohibit fraud on the part of both purchasers and sellers of securities. 15 U.S.C. § 78j(b) (1970) and 17 C.F.R. § 240.10b-5 (1972) (both prohibiting fraud "in connection with the purchase or sale of any security"). See generally 1 BROMBERG §§ 2.1, 2.3(100), 2.3(800). Thus, the situations discussed in this article, being limited to suits by makers against payees, would fall exclusively under the 1934 Act.

The 1934 Act, § 3(a)(13), 15 U.S.C. § 78c(a)(13) (1970), defines the word "purchase" as "includ[ing] any contract to buy, purchase, or otherwise acquire." It should be noted that all of the definitions in § 3(a) are limited by the phrase "unless the context otherwise requires."

5. The 1934 Act, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1970) states:

The term "security" means any note, stock, treasury stock bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include any currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited. (Emphasis added.)

It constantly must be remembered that this definition is likewise limited by the phrase "unless the context otherwise requires."

Although this definition of a "security" is slightly different from that found in § 2(1) of the 1933 Act, 15 U.S.C. § 77b(1) (1970), both the Senate Report and the Supreme Court have recognized that the two definitions are functional equivalents. S. REP. NO. 792, 73d Cong., 2d Sess. 14 (1934) ("substantially the same"); *Tcherepnin v. Knight*, 389 U.S. 332, 336, 342 (1967) ("virtually identical"). See generally 2 LOSS 795-96; 5 *id.* 2729.

6. See *supra* notes 4 and 5.
7. 321 F. Supp. 806 (S.D.N.Y. 1970).

be faced with the issue in the context of the maker suing the payee,⁸ federal

jurisdiction could be invoked with respect to any claim of fraud in connection with the issuance of a check or note, no matter how small the transaction (e.g., the purchase of an automobile or refrigerator), provided the mails or some other instrumentality of interstate commerce were used. . . . [T]he maker of the note or check as well as the payee would be entitled to sue.⁹

And although the *Movielab* court did "not view this as the type of situation that prompted the enactment of the federal securities laws,"¹⁰ it did in fact answer the questions affirmatively. Since that case, two other federal courts have agreed¹¹ and two have disagreed¹² with that answer.

The number of everyday transactions in which promissory notes are given makes the resolution of this conflict significant for not only the securities specialist, but indeed for all lawyers. If the three decisions answering the questions affirmatively are correct, then the unwary may well find that any dispute concerning a promissory note given to him presents a federal case and a shift in the applicable law from the state laws of sales, warranties and negotiable instruments to the federal securities acts. The premise of this article is that the question should be answered in the negative: The payee of an "ordinary commercial note" given for a purpose other than the general financing of the maker's business is not a "purchaser" of a "security" within the meaning of the 1934

8. In the prior case of *City Nat'l Bank v. Vanderboom*, 290 F. Supp. 592 (W.D. Ark. 1968), *aff'd*, 422 F.2d 221 (8th Cir. 1970), *cert. denied*, 399 U.S. 905 (1970), the makers of notes counterclaimed against the suing payee-bank, but not on the theory that the payee had fraudulently purchased the notes. Rather the theory aired in both the lower and appellate courts was that the payee, through one of its officers and agents, had participated in a fraudulent sale of stock in a corporation owned by the agent and others. The proceeds of the notes were used by the makers to purchase the stock of a corporation formed by them. The maker's corporation then bought all of the stock in the agent's corporation. The courts held that the payee was not a seller of the stock in the agent's corporation. This case is discussed more fully in note 80 *infra*.

9. 321 F. Supp. at 808.

10. *Id.*

11. *Lino v. City Investing Co.*, Civil No. 1439-71 (D.N.J. April 25, 1972); *MacAndrews & Forbes Co. v. American Barmag Corp.*, 339 F. Supp. 1401 (D.S.C. 1972).

12. *McClure v. First Nat'l Bank*, 352 F. Supp. 454 (N.D. Tex. 1973); *Joseph v. Norman's Health Club, Inc.*, 336 F. Supp. 307 (E.D. Mo. 1971).

Act.¹³ He should, therefore, not be subject to the maker's suit in the federal courts absent some other jurisdictional basis.

Part II of this article will analyze the few cases posing the specific issue in the light of the statute itself, its legislative history, and the relevant case law. Part III will explore the many ramifications of an affirmative answer to the questions. Part IV will suggest various criteria to aid in the determination of whether a particular instrument is an "ordinary commercial note," falling outside the ambit of the 1934 Act, or an "investment note," falling within the federal law. The discussion will be limited primarily to situations involving suits by the makers of notes against their payees.

II. THE CASES PRO AND CON

A. THE CASES PRO

The three cases answering affirmatively the issues posed followed similar lines of reasoning. In *Movielab* the maker of the notes in question purchased from the payee certain film processing and optical businesses. Three promissory notes were given for the businesses. Two were eight per cent installment notes for 5,250,000 dollars each, payable over twenty years, and the other was a shorter term note for 4,178,312 dollars. The maker sued the payee in federal district court, alleging fraud under section 10(b) of the 1934 Act and Rule 10b-5. The fraud was based on alleged false representations and concealment of certain material facts. The maker sought damages and rescission.

The federal court rejected the payee's claim that the notes were not "securities," but instead constituted a mere individual loan of the type not encompassed within the 1934 Act. The court admitted that the purpose of the federal antifraud provisions was to protect

13. See *supra* notes 4 and 5. "Ordinary commercial note" as used in this article describes a note with those characteristics analyzed in Part IV *infra* which cause it to be one which should not be treated as a "security" under the 1934 Act. The phrase "ordinary commercial note" does not comprehend short term commercial paper which literally falls within the express exception to the definition of a "security." See *supra* note 5. Such short term paper raises totally different issues beyond the scope of this article. See generally Comment, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362 (1972).

In contrast, "investment note" will be used in this article to describe a note possessing those characteristics which cause it to be one which should be treated as a "security" under the 1934 Act. Whenever it is said in this article that a note "is not a security," it is meant that the note is not an "investment note."

investors and that "if instruments used in every private loan transaction qualified as securities under the federal statutes,"¹⁴ then federal jurisdiction could be invoked with respect to any claim of fraud involving checks and notes no matter how small the transaction. The court even expressed its belief that such situations were not of the type that prompted the passage of the federal securities laws. But the court then read the definition of "security" in the 1934 Act and found "in unequivocal and all-embracing language, that 'The term "security" means *any note*.'"¹⁵ The court reasoned that "this plain language, literally read, clearly includes promissory notes of the type that are the subject of the present suit."¹⁶

The *Movielab* court cited various 1940-vintage Supreme Court decisions to support its plain meaning-literal language approach to statutory interpretation. It attempted to bolster its reasoning by noting that other courts had reached the same result, "holding that the issuance of a promissory note as part of a private commercial transaction constitutes the 'sale' of a security within the meaning of the anti-fraud provisions of both the 1933 and 1934 Acts."¹⁷ But the essence of the court's opinion appeared in the following language:

14. *Movielab, Inc. v. Berkey Photo, Inc.*, 321 F. Supp. 806, 808 (S.D.N.Y. 1970).

15. *Id.*

16. *Id.*

17. *Id.* at 809. The court cited various lower federal court decisions supporting this view, including the leading case of *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954). *Llanos* involved a criminal prosecution for fraud under the 1933 Act and for mail fraud. The court of appeals affirmed the defendants' convictions for fraudulently offering and selling promissory notes on the basis of false representations. The *Movielab* court failed to recognize at least two distinctions between the situation it faced and that presented in *Llanos*. First, *Llanos* in fact did not involve what the *Movielab* court itself characterized as "a private commercial transaction" for the sale of assets, such as the one before it. *Movielab, Inc. v. Berkey Photo, Inc.*, 321 F. Supp. 806, 809 (S.D.N.Y. 1970). On the contrary, *Llanos* involved the sale of notes to many individuals, perhaps even a public offering of such instruments, to finance a criminal enterprise. Second, *Llanos* was a criminal prosecution against a maker of notes and did not involve a civil suit by a maker against a payee.

The *Movielab* court also relied upon the often-cited case of *Lehigh Valley Trust Co. v. Central Nat'l Bank*, 409 F.2d 989 (5th Cir. 1969). The *Lehigh* court's unfortunate statement, quoted in *Movielab*, that the "definition of a security has been literally read by the judiciary to the extent that almost all notes are held to be securities," *id.* at 991-92, will be discussed more fully later.

Try as we may, we fail to detect in the 1934 Act any grant of discretionary power to the court to construe the term "security" as including certain types of notes but not others. Congress apparently decided that it would pass a sweeping prohibition rather than attempt to draw such distinctions. We are bound by that decision.¹⁸

As will become apparent in further discussions of the *Movielab* case in this article, this writer believes that the result in the case may have been proper,¹⁹ but that the reasoning employed by the district court to reach its result was highly erroneous. The court's belief that small check and note transactions did not prompt the enactment of the federal securities laws was no doubt well-founded, but if the court meant to imply that the factual situation before it was also of the type not intended to be covered by the federal acts, then that implication is questionable. Thus, the criticisms leveled at the *Movielab* case are not directed at its result but rather at its reasoning. For this reason, the case will be analyzed in Part IIB in terms of its reasoning only. The result in *Movielab* will be discussed in other parts of this article.²⁰

The federal district court in *MacAndrews & Forbes Co. v. American Barmag Corp.*²¹ reached the same result as *Movielab* in another suit by a maker of notes²² against their payees. The notes were given to the payees in exchange for machinery. The maker, alleging various misrepresentations concerning the capabilities of the machines it purchased, based its right to recovery on Rule 10b-5.²³

The court, citing *Movielab*, repeated the statement that "the definition of security . . . is unequivocal and all-embracing."²⁴ The

18. 321 F. Supp. at 809. The district court's decision in *Movielab* was affirmed *per curiam* by the Second Circuit. 452 F.2d 662 (2d Cir. 1971). For a discussion of the nebulous grounds of the affirmation, see Parts IVD-E, *infra*.

19. See Parts IIC, IVD-E and V *infra*.

20. See *supra* note 19.

21. 339 F. Supp. 1401 (D.S.C. 1972).

22. The instruments in question in *MacAndrews* were actually bills of exchange, but as the court stated, "A bill of exchange, of course, is merely a form of a note." *Id.* at 1406.

23. The maker also alleged violations of the 1933 Act. The court sustained the maker's right to relief under that Act as well as under the 1934 Act, provided the allegations were true. *Id.* at 1407. The court thus totally ignored the distinction between a fraudulent "purchase," allegedly involved in the case, and a fraudulent "sale," not at all presented by the facts. See *supra* note 4. The maker's complaint also set forth a count based on breaches of express and implied warranties.

24. 339 F. Supp. at 1406.

court continued by noting that Congress did not intend a strict construction of the word "security." Also, the Supreme Court had indicated that the words used in the definition of "security" were generic terms which should be given very broad meanings.²⁵ In conclusion, the court found that the notes were "securities" and their issuance was a "sale."

The third case answering the questions posed in the affirmative was *Lino v. City Investing Co.*²⁶ In *Lino* the maker of six promissory notes totalling 50,000 dollars sued the payee's parent corporation,²⁷ alleging a misstatement of material facts. The notes were given to the payee for two franchise agreements. The district court accepted the maker's assertion that the notes were securities and that the allegations, if true, constituted a fraudulent purchase on the part of the payee. The court, recognizing its holding to be "an extreme result" which meant "that any maker of a promissory note who is fraudulently induced to purchase an object could avail himself of a federal forum to redress the wrong," concluded that the "clear language" of the statutes compelled that result.²⁸

B. ANALYSIS OF THE REASONING OF THE CASES PRO

The reasoning of each of the three courts which gave affirmative answers to the questions posed reveals the same flaws. This reasoning will be examined in the light of the statute itself, its legislative history, and the relevant case law.

1. *The Statute Itself*

Not one of the three courts recognized the cardinal rule embodied in the statute itself that the definitions given are to be applied only if the context does not otherwise require.²⁹ It seems strange that the *Lino* court, apparently reluctant to reach its "extreme result," and the *MovieLab* court, which seemed to believe that the situation before it was not of the type that prompted the

25. See note 51, second paragraph, *infra*.

26. Civil No. 1439-71 (D.N.J. April 25, 1972).

27. For a discussion of the liabilities of a "controlling person," see Part IIIA2 *infra*.

28. Civil No. 1439-71 at R. 180a-89a. The district court's decision in *Lino* was certified for interlocutory appeal to the Third Circuit pursuant to 28 U.S.C. § 1292(b) (1970). The case is presently pending. *Id.*, appeal docketed, Nos. 72-1672, 72-1673, 3d Cir., Aug. 7, 1972.

29. The 1934 Act, § 3(a), 15 U.S.C. § 78c(a) (1970) sets forth the definitions to be "used in this chapter, *unless the context otherwise requires.*" (Emphasis added.)

passage of the Act, failed to explore—or even mention—this principle. Surely Congress, by explicitly requiring the context-over-text method of construction, intended that this requirement be as “unequivocal and all-embracing” as the language used in the definitions themselves. Certainly this method of statutory construction is more difficult than the plain meaning-literal language approach, but the context-over-text method is compelled by the need for flexibility “to meet the countless and variable schemes devised by those who seek the use of the money of others.”³⁰ Thus, the question is one of *statutory interpretation* by an analysis required by the statute itself. The court in *Movielab* confused this interpretive analysis with *discretion* “to construe the term ‘security’ as including certain types of notes but not others.”³¹ Indeed, unless the “context” language of the statute is to be rendered meaningless, it is manifest that Congress did in fact mean to say that some notes are securities while others properly may not be so treated. The position taken by this article, that ordinary commercial notes are not securities, essentially is based on the premise that the context *does* require non-security treatment for such notes.

The three courts also avoided the statement in the 1934 Act of the reasons for its passage. The statute recites the necessity to control

transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets . . . transactions by officers, directors, and principal securities holders, . . . transactions . . . carried on in large volume by the public generally . . . [and] manipulation and control [of securities prices, which] gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities.³²

This language does not connote a need to regulate ordinary commercial notes arising from private loan transactions.

2. Legislative History

Not only did the *Movielab*, *MacAndrews* and *Lino* courts disregard the context-over-text approach compelled by the statute and the recited reasons for the passage of the 1934 Act, but they also ignored the import of the legislative history of the 1933 and 1934 Acts.³³ Although there is no history on whether ordinary com-

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

31. *Movielab, Inc. v. Berkey Photo, Inc.*, 321 F. Supp. 806, 809 (S.D.N.Y. 1970).

32. The 1934 Act, § 2, 15 U.S.C. § 78b (1970).

33. The *Movielab* court paid lip service to legislative intent:

The primary purpose behind the adoption of the antifraud

mercial notes are to be included in the definition of a "security," the history of both the 1933 and 1934 Acts reveals a preoccupation with *investment* instruments.

President Roosevelt's messages to Congress on both Acts indicate his concern with investments.³⁴ Similarly, the concept of regulating investments permeates the Congressional reports on both Acts. The Senate Report accompanying the 1933 Act states:

The purpose of this bill is to protect the *investing public* and honest business. The basic policy is that of informing the *investor* of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation.³⁵

The House report on the 1933 Act states that the definition of "security" is "in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the *ordinary concept of a security*."³⁶

The legislative history behind the 1934 Act also indicates an intent to control investment instruments without any concern over what this article describes as "ordinary commercial notes." Specifically referring to section 10(b), the Senate Report states that "Subsection (b) authorizes the Commission by rules and regulations to prohibit or regulate the use of any other manipulative or deceptive practices which it finds detrimental to the interests of the

provisions of the 1933 and 1934 Acts was to protect public investors against fraud in the sale of securities of the type normally offered in the market place.

Movielab, Inc. v. Berkey Photo, Inc., 321 F. Supp. 806, 809 (S.D.N.Y. 1970). But, as has been seen, the court proceeded to ignore this intent by invoking the plain meaning-literal language approach to statutory construction.

34. The President's March 29, 1933, message to Congress, prompting the 1933 Act, is found at S. REP. No. 47, 73d Cong., 1st Sess. 6 (1933), and at H.R. REP. No. 85, 73d Cong., 1st Sess. 1 (1933) ("supervision of traffic in investment securities in interstate commerce"). His Feb. 9, 1934, message urging the legislation of what became the 1934 Act is found at S. REP. No. 792, 73d Cong., 2d Sess. 1 (1934), and at H.R. REP. No. 1383, 73d Cong., 2d Sess. 1 (1934) ("supervision of the purchase and sale of all property dealt with on exchanges;" "regulating the investment business").
35. S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933) (emphasis added).
36. H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933) (emphasis added). The Conference Report on the 1933 Act reveals that there was no disagreement between the two Houses on the purpose of the Act or on the definition of a "security." See H.R. REP. No. 152, 73d Cong., 1st Sess. 24 (1933).

investor."³⁷ The House Report is also pregnant with the purpose of protecting investors.³⁸

The emphasis in all this legislative history on investment instruments indicates that Congress certainly was not concerned with regulating ordinary commercial notes. This emphasis was enacted into law by the inclusion of the required context-over-text method of statutory interpretation in the 1933 and 1934 Acts. It is disappointing that the *Movielab*, *MacAndrews* and *Lino* courts did not resort to this legislative history to inform themselves of the import of the statute's context-over-text language which they disregarded.

3. Relevant Case Law

The Supreme Court on numerous occasions has breathed life into the context-over-text language of the statute by requiring that "in searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality."³⁹ That this has always been the view of the Court is exhibited by its statement in the early case of *SEC v. C.M. Joiner Leasing Corp.*⁴⁰ that the

rules of statutory construction . . . long have been subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose, will read text in the 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.⁴¹

37. S. REP. NO. 792, 73d Cong., 2d Sess. 18 (1934) (emphasis added).

38. See H.R. REP. NO. 1383, 73d Cong., 2d Sess. 30 (1934). Again, the Conference Report on the 1934 Act reveals no dispute as to the purpose of the legislation or as to the definition of a "security." See H.R. REP. NO. 1838, 73d Cong., 2d Sess. 30 (1934).

39. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967), citing *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946). In *Tcherepnin*, the Court held that withdrawable capital shares issued by a savings and loan association to evidence savings accounts were "securities" under the 1934 Act. In *Howey* the Court held that the offering of units of a citrus grove development coupled with service contracts constituted an offering of "investment contracts" within the meaning of § 2(1) of the 1933 Act, 15 U.S.C. § 77b(1) (1970), defining "security" as including any "investment contract."

40. 320 U.S. 344 (1943).

41. *Id.* at 350-51 (emphasis added). In *Joiner* the Court held that certain assignments of oil leases were "securities" under the 1933 Act. In accord with *Joiner*, *Howey* and *Tcherepnin* is the Court's decision in *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967), holding that a certain type of variable annuity contract was a "security" under the 1933 Act.

Although all of these Supreme Court pronouncements are found in decisions holding that various instruments *were* securities, the context-over-text or substance-over-form method of statutory construction has been used to *exclude* other transactions from the definitions in the federal securities laws. The Third Circuit's decision in *First Trust & Savings Bank v. Fidelity-Philadelphia Trust Co.*⁴² is particularly enlightening. In this case a customer of the defendant Fidelity delivered to it what purported to be negotiable promissory notes of a whiskey distiller. Accompanying the notes were what purported to be negotiable warehouse receipts evidencing deposits of whiskey, which was to serve as collateral for the notes. The purported warehouse receipts were deposited in Fidelity's trust department, which issued in return safekeeping receipts. The notes were left with Fidelity's collection department along with drafts drawn by the customer in its own favor on the plaintiff, which was to be the purchaser of the notes. Fidelity credited its customer's account for the amount of the drafts and charged the customer interest until the transactions were completed. Fidelity then forwarded the drafts, notes and safekeeping receipts to the plaintiff in order to close the transactions. The plaintiff in turn sent to Fidelity checks payable to the defendant's order. When the checks cleared, Fidelity was thus reimbursed for the credits to the customer's account. Both the notes and warehouse receipts were in fact spurious. The plaintiff sued Fidelity on the theory that the defendant was a "seller" under the 1933 Act.

Finding Fidelity to be a mere agent for collection performing an ordinary banking function, the Third Circuit affirmed the district court's decision that the defendant was not a "seller" of securities. The court of appeals stated:

If this set of facts constitutes Fidelity a seller under the Securities Act, it seems to us inevitable that every bank which advances money to a customer upon a sight draft and negotiable bill of lading is also a seller.⁴³

Although the court recognized that the definitions of the 1933 Act are very broad and comprehensive, it refused to be

pushed into the startling conclusion that every bank that makes an advance on an instrument left with it for collection, and passes that instrument on to someone else, has become a seller under the terms of the federal statute, if the transaction is one in interstate commerce.⁴⁴

Although the *Fidelity* court never mentioned the context-over-

42. 214 F.2d 320 (3d Cir. 1954), *cert. denied*, 348 U.S. 856.

43. 214 F.2d at 323.

44. *Id.*

text language of the 1933 Act,⁴⁵ every page of the opinion affirms that the court was looking at form over substance. And although the dispute was analyzed in terms of whether Fidelity was a "seller," rather than in terms of whether Fidelity issued "securities," the decision is significant as a model of the type of reasoning compelled by the statutes themselves.

Two other cases involving private loan transactions should be noted. *Beury v. Beury*⁴⁶ was a stockholders' derivative action based on allegedly fraudulent stock transactions. One of the allegations was that the corporation on whose behalf the suit was brought loaned⁴⁷ at least 70,000 dollars to one of the defendants. This portion of the case presents a situation that is the converse of that posed in this article since the giver of the loan, through its stockholders, was suing the recipient of the loan, as opposed to the recipient of the credit (as is a maker of a note) suing the giver of the credit (the payee). Nevertheless, the case is significant for the court's view that "the \$70,000 loan cannot be considered to be a transaction in securities within the meaning of the Securities Exchange Act of 1934."⁴⁸ This conclusion, however, must be viewed as *dicta* since there was no allegation of damage resulting from the loan.

The other case, *SEC v. Fifth Avenue Coach Lines, Inc.*,⁴⁹ involved many transactions allegedly violative of the federal securities laws. Several of the allegations were based on loans and notes; in not one of these transactions did the court find that the loans or notes were securities. Its holding with respect to three of the notes is representative of its statements regarding each of the other loan and note transactions:

Regardless of the terms of the notes, they do not constitute securities within the fair meaning of the Acts. The "personal loan" cases relied upon by plaintiff are for the most part distinguishable. They involve either investment contracts or a whole series of notes, not one or two. The transactions here are individual loans.

45. Section 2 of the 1933 Act, 15 U.S.C. § 77b (1970), states in language identical to that found in the 1934 Act, that the definitions it sets forth are to be used "unless the context otherwise requires."

46. 127 F. Supp. 786 (S.D.W. Va. 1954).

47. Although the *Beury* opinion does not indicate whether the loan was evidenced by a note, there is no doubt that a writing is not essential to the existence of a security. 1 Loss 458, 488-89 (citing both legislative history and the Supreme Court). Thus, the determination of whether a security was involved in *Beury* could not have turned on whether or not the loan was evidenced by a written note.

48. 127 F. Supp. at 789. See *supra* note 47.

49. 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.⁵⁰

Again, despite the fact that the *Beury* and *Fifth Avenue* courts refrained from mentioning the context-over-text provisions of the statutes, both analyzed the situations in terms of substance over form.

In contrast, the courts in *Movielab* and *MacAndrews* chose to rest their decisions on other judicial authority.⁵¹ Reliance in both was placed on *Lehigh Valley Trust Co. v. Central National Bank*.⁵² The *Movielab* court quoted⁵³ *Lehigh's* generalization that the "definition of a security has been literally read by the judiciary to the extent that almost all notes are held to be securities."⁵⁴ This

50. 289 F. Supp. at 38, citing *Beury* and 1 Loss 546.

51. The *Movielab* court distinguished *Beury* on the basis that in *Beury* it did not appear whether the loan was evidenced by a note. *Fifth Avenue* was distinguished because there the court treated the question as one involving a "personal loan" rather than a "note." *Movielab, Inc. v. Berkey Photo, Inc.*, 321 F. Supp. 806, 810 (S.D.N.Y. 1970). Both distinctions are specious. With regard to *Beury*, it has already been noted that the existence of a security does not depend on the presence of a written instrument. See *supra* note 47. And as to *Fifth Avenue*, the entire point was that the notes were not securities because they were mere personal loans. See text accompanying note 50 *supra*. *MacAndrews* cited neither *Beury* nor *Fifth Avenue*.

Both the *Movielab* and *MacAndrews* courts cited one or more of the Supreme Court's opinions in *Joiner*, *Howey* and *Tcherepnin*; both missed the principles laid down by the Court in those cases. *Movielab* chose to distinguish the three Supreme Court opinions on the basis that none of them involved notes; no mention was made of the substance-over-form approach mandated by the cases. 321 F. Supp. at 810. *MacAndrews* cited *Tcherepnin* for the proposition that the words used in the definition of "security" are generic words which are to be given very broad meanings. *MacAndrews & Forbes Co. v. American Barmag Corp.*, 339 F. Supp. 1401, 1406 (D.S.C. 1972). The court, however, did not recognize that the substance-over-form approach can, and in appropriate cases should, be used to exclude as well as include instruments within that definition.

52. 409 F.2d 989 (5th Cir. 1969). Both courts also relied on *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1953). For a discussion of the features of *Llanos* which distinguish it from the situations presented in *Movielab*, *MacAndrews* and *Lino*, see *supra* note 17.

53. 321 F. Supp. at 809. Again it is proper to note that the result in *Movielab* may have been proper, see *infra* Parts IIC, IVD-E, and V, but that its reasoning was erroneous. The cases upon which the *Movielab* court relied did not support its reasoning or result, although other cases and reasoning could have been used to reach that same result.

54. 409 F.2d at 991-92. The *Lehigh* court cited the *Llanos* case among others as authority for this proposition.

broad statement is unfortunate for at least three reasons. First, it condones rather than condemns the plain meaning-literal language approach in contravention of the statute's command to examine context over text. Second, the statement simply did not depict correctly the views of the entire judiciary.⁵⁵ Last, and most important, the "security" involved in *Lehigh* was a loan participation and not a note; the proposition was thus mere *dicta*.⁵⁶

The Fifth Circuit later relied solely on its *Lehigh* generalization in finding a note to be a security in *Rekant v. Desser*,⁵⁷ a derivative action. The stockholders sued Desser, the president and a director of their corporation, for fraudulently inducing the corpo-

55. The *Lehigh* court did cite *Beury* as contrary to its assertion; no mention was made of the *Fifth Avenue* case, however, despite the fact that it was also contrary to the broad generalization.

56. The *Lehigh* court recognized that it was not faced with a note situation: "Central Bank, however, is not charged with the sale of the Larso Development note, but rather with the sale of the loan participation." 409 F.2d at 992. The facts were that Larso had attempted to obtain from Central Bank a loan of \$325,000. Central Bank, being able to lend Larso only \$185,000, agreed to help raise the funds by selling participation interests in a \$325,000 loan evidenced by a note. The note was guaranteed by certain individuals and was secured by 423,000 shares of stock in another corporation. The prime guarantor was the power behind both Larso and the other corporation whose stock served as collateral for the note. *Lehigh* Trust purchased from Central Bank a loan participation, and when the loan became uncollectible, *Lehigh* sued Central Bank under Rule 10b-5, alleging misrepresentations and failure to disclose material facts relating to the credit standing of the prime guarantor and the value of the collateral stock. The court affirmed a jury verdict for *Lehigh* and stated that the loan participation agreement "is clearly within the statutory definition of a security as that definition includes 'any certificate of interest or participation in . . . any of the foregoing [note, stock, etc.]'" 409 F.2d at 992.

Two features of *Lehigh* should be noted. First, the suit was by the purchaser of a loan participation against its seller, not by the maker of a note against its payee as in *Movielab*, *MacAndrews* and *Lino*. Second, the case is a vivid illustration of a situation where a note itself may not be a security while a loan participation in the note is. That is, if the suit had been against the maker Larso on the note itself, the dispute probably would have involved what this article terms an "ordinary commercial note," since presumably Central Bank was the payee and the transaction was a simple, albeit large, bank loan. On the other hand, since the suit was against Central Bank on the loan participation, the decision of the court was probably correct because Central Bank essentially had offered and sold to an apparently large group of persons participations in the Larso enterprise. Such persons might properly be viewed as investors.

57. 425 F.2d 872, 878 (5th Cir. 1970).

ration to issue to him treasury shares and a note for grossly inadequate consideration.⁵⁸ The case is superficially similar to the situation presented by the questions posed in this article because the stockholders, suing derivatively on behalf of the corporate maker, sought recovery against the payee of the note. But it was unnecessary to find the note to be a security. The stock and the note were issued in the same transaction, and the stock was certainly a "security" sufficient in itself to support the Rule 10b-5 action; the federal court would have had jurisdiction over the entire controversy, including the note aspects, under the doctrine of pendent jurisdiction.⁵⁹

The *Movielab* and *MacAndrews* courts cited other lower federal court decisions to support their findings that the notes in question were securities. Both courts cited *SEC v. Vanco, Inc.*⁶⁰ In that case more than six hundred former shareholders of a bankrupt

58. The grossly inadequate consideration was a 167 acre parcel of land purchased by the corporation for \$1,100,000 but allegedly worth only \$150,000. The corporation paid for the land by issuing to Desser the treasury shares and note. In the context presented, it is doubtful that the note should have been treated as a security since the transaction involved merely the issuance of a single note in exchange for a single piece of property. The note was not given for the general financing of the corporation. Furthermore, there was no offering of notes to several or many persons: the negotiations were solely between two persons, the corporation and Desser. For a more complete enumeration of the factors by which the note might have been characterized, see *infra* Part IV.

Of course the stock was properly treated as securities, but it is not unusual for assets to be purchased by the issuance of securities and the giving of other property which is not a security. Witness especially the case of *Errion v. Connell*, 236 F.2d 447 (9th Cir. 1956), strikingly similar to *Rekant* in several respects. In *Errion* the plaintiff had been fraudulently induced by the defendant to give him stock, notes, an annuity insurance policy and three conditional sales contracts for realty, in exchange for land owned by the defendant and his corporations. Although the court did not specifically discuss whether the notes were securities, it quite properly framed the issue as "whether a district court under the Act of 1934 has jurisdiction when there is a *single transaction or scheme* which involves both securities and non-securities." *Id.* at 453-54 (emphasis in the original). The court proceeded to hold that the securities involved supported a Rule 10b-5 action cognizable on its own in the district court, and that the district court properly awarded damages for the entire scheme even though non-securities were involved. The holding was based on the doctrine of pendent jurisdiction.

59. See *supra* note 58; 1 Loss 1006; 5 *id.* at 2960-67; 6 *id.* at 3604-05. See generally C. WRIGHT, LAW OF FEDERAL COURTS § 19 (2d ed. 1970).

60. 166 F. Supp. 422 (D.N.J. 1958).

corporation were solicited to advance at least ten per cent of the amount of their original investment in the corporation to Vanco. "In exchange, a *subscribing shareholder* would receive the defendant's renewable promissory note maturing in six months *and an interest in Vanco, Inc. represented by shares of its capital stock.*"⁶¹ The court held that it was unlawful for Vanco "to use the mails to sell or offer to sell these notes *and stock interests*" without registration.⁶² Even if the stock aspects of the case were not present, it is unquestionable that the case involved the public offering of investment notes to prospective investors. That the publicly-offered notes in *Vanco* should be characterized differently than the notes in *Movielab*, *MacAndrews* and *Lino* is equally clear.

The case of *SEC v. Addison*⁶³ also appeared in both *Movielab* and *MacAndrews*. In *Addison* the defendants issued notes to approximately four hundred persons "for the stated purpose of financing the defendants' mining operations."⁶⁴ Written agreements were delivered to the lenders stating that the defendants would execute contracts conveying to the lenders a percentage interest in the income and profits derived from the mining operations and properties. The court succinctly described the case when it said:

[T]he defendants needed money to get into operation and . . . in order to finance such operation, they were soliciting unconditional unsecured loans of money from members of the general public.⁶⁵

Again there can be no doubt that the persons solicited in *Addison* were prospective investors; the notes involved were true investment instruments. The same court that decided *Addison* explicitly recognized this as the basis for that opinion in the recent case of *McClure v. First National Bank*,⁶⁶ a thoughtful decision involving a suit by the maker of ordinary commercial notes against their payees which reaches a result opposite from *Movielab*, *MacAndrews* and *Lino*.

Both *Movielab* and *MacAndrews* also cited *Whitlow & Associates, Ltd. v. Intermountain Brokers, Inc.*,⁶⁷ a suit by a principal against its agent for violations of Rule 10b-5 and the 1933 Act.

61. *Id.* at 423 (emphasis added).

62. *Id.* (emphasis added).

63. 194 F. Supp. 709 (N.D. Tex. 1961).

64. *Id.* at 715.

65. *Id.*

66. 352 F. Supp. 454, 461 (N.D. Tex. 1973). The *McClure* case will be discussed in detail shortly.

67. 252 F. Supp. 943 (D. Hawaii 1966).

The agent repeatedly had assured his principal that he would be able to place a loan of 550,000 dollars for it. After unsuccessfully contacting several prospective lenders, the negotiations finally settled on Intermountain. A good faith deposit of 11,000 dollars was given to Intermountain, which declared a forfeiture of the deposit as a result of an inappropriately-worded letter by the agent. The principal sought the return of its 11,000 dollars. The court, relying heavily on *Vanco* and *Addison*, both clearly distinguishable, found for the principal. Although arguably this case involved an investment note,⁶⁸ it is submitted that if the transactions had been subjected to the criteria suggested in Part IV of this article, then the note would have been found to be an ordinary commercial note not falling within the federal securities laws. In any event, *Whitlow* does not provide authority persuasive enough to support the *MacAndrews* or *Lino* decisions since those cases did not involve notes arguably falling within the gray area between investment notes and ordinary commercial notes. And at best the case gives some support to the *Movielab* result, since the notes in *Movielab* probably did fall within that gray area; still, little could be done to salvage *Movielab's* reasoning.

The *Movielab* court also cited *Olympic Capital Corp. v. Newman*⁶⁹ and *Prentice v. Hsu*.⁷⁰ In *Olympic* it was "not questioned by any party" that the note involved was a security. The court merely cited one case⁷¹ on this point and proceeded to discuss more fully the question of whether there was a "sale" of that security. In *Prentice* the payee of certain notes sued the maker, alleging fraud under the 1933 Act and Rule 10b-5. The payee alleged that he had been induced to advance money in exchange for the notes by the maker's false promise that he would invest more than 1,000,000 dollars in stock of the payee's corporation, and by the maker's misrepresentations that he had a valuable contract which he would assign to the corporation and that he had a secret cache of securities and cash in Formosa which he would make available for investment in the corporation. The advance was to be used to retrieve the hidden valuables in Formosa.

The court's opinion in *Prentice*, more concerned with the mak-

68. The agent had apparently solicited unsuccessfully several prospective lenders to finance his principal's proposed leasehold venture; this aspect of the case arguably involved a public offering, though the inference is weak.

69. 276 F. Supp. 646 (C.D. Cal. 1967).

70. 280 F. Supp. 384 (S.D.N.Y. 1968).

71. *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1953). See *supra* note 17.

er's invocation of the privilege against self-incrimination than with securities law, briefly held that the notes were securities on the authority of two cases which involved public offerings of notes.⁷² It seems that a better basis for the decision would have been that there was an offer, an acceptance, and therefore a technical sale of the stock; thus, there was a fraudulent purchase of stock on the part of the maker since the transaction was "in connection with the purchase . . . of any security."⁷³ That the stock was never issued to the maker is of no import; the failure was the result of the fraud itself. Furthermore, the misrepresentation in a Rule 10b-5 action need not relate to the security itself.⁷⁴ Certainly from the payee's standpoint the transactions were incident to the maker's promised investment of 1,000,000 dollars in the corporation's stock. Neither the *Prentice* case with its extremely superficial analysis on the note issue, nor the *Olympic* case, where the issue was not even contested, provides a solid foundation for the *Movielab* reasoning.

Thus, the decisions in *Movielab*, *MacAndrews* and *Lino* were all based on faulty reasoning. None of the three courts recognized the instruction on the face of the statute that the context should govern the text. None of them utilized the legislative history behind the federal securities laws; such history would have revealed Congress' preoccupation with the purpose of protecting *investors* and the absence of any purpose of protecting those who extend or receive credit in ordinary commercial transactions. Finally, none of them adequately analyzed the problem in terms of the substance over form approach mandated by the Supreme Court itself and properly followed by other federal courts. Instead, all three of them relied on cases inapposite to the situations before them.

C. THE CASES CON

In contrast to the tenuous reasoning of the *Movielab*, *MacAndrews* and *Lino* decisions, the two cases reaching a contrary result present a more satisfying analysis. In *Joseph v. Norman's Health Club, Inc.*⁷⁵ the plaintiffs in four consolidated class actions sued the payees of notes on two theories. The first was that the plaintiffs, the makers of the notes, were fraudulently induced to give their notes to the payees in exchange for lifetime memberships in the Health Club. The payees endorsed the notes over to finance

72. *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1953) and *SEC v. Vanco, Inc.*, 166 F. Supp. 422 (D.N.J. 1958).

73. See *supra* notes 1, 4.

74. 6 Loss 3604.

75. 336 F. Supp. 307 (E.D. Mo. 1971).

companies. This theory was based on Rule 10b-5; the premise was that the makers were "sellers" of "securities"—and the notes were the "securities." Implicit in this theory is the allegation that the payees were "purchasers" of the "securities" and that the violation was a "fraudulent purchase."⁷⁶ The alleged fraud consisted of material misrepresentations and omissions relating to the payees' failure to disclose the cash price of the services sold, information concerning finance charges, and the failing financial condition of the Health Clubs. The same misrepresentations formed the grounds for the second theory, founded on alleged violations of the federal Truth-in-Lending Act.⁷⁷

The court in analyzing the securities issue was careful to note the "plaintiffs [did] not allege that they *purchased* a security"⁷⁸—rather they alleged that they were *sellers* of securities. After recognizing that several courts had read the statute literally to find almost all notes to be securities,⁷⁹ the *Joseph* court proceeded to analyze the case before it in terms of context-over-text. The court first cited the Supreme Court decisions in *Howey* and *Tcherepnin* for the proposition that the definition of "security" is flexible, not static. The court then held "that the context of the present case . . . requires that the promissory note is other than a security within the meaning of" the 1934 Act.⁸⁰ The court also stated:

76. See *supra* note 4.

77. 15 U.S.C. § 1640 (1970).

78. 336 F. Supp. at 313.

79. The court cited the *Rekant*, *Llanos*, *Olympic*, *Whitlow* and *Lehigh* cases. *Id.*

80. 336 F. Supp. at 313. The court throughout its opinion relied heavily on both the lower and appellate court opinions in *City Nat'l Bank v. Vanderboom*, 290 F. Supp. 592 (W.D. Ark. 1968), *aff'd*, 422 F.2d 221 (8th Cir. 1970), *cert. denied*, 399 U.S. 905. The facts in *Vanderboom* are set forth *supra* in note 8. It should be remembered that in *Vanderboom* the theory of the defendant-maker was not that he was a seller of securities, but that the payee engaged in a fraudulent sale of stock. In response to this position the district court stated, 290 F. Supp. at 608-09:

The short answer to defendants' contention is that the plaintiff bank did not sell or offer to sell any security of any kind to the defendants. The defendants approached the bank and expressed a desire to borrow money which they, of their own volition, intended to use in the purchase of the capital stock of a corporation, Investors Thrift Corporation, organized by themselves [to purchase all of the stock in the corporation owned by the bank's agent and others]. When the proceeds of the notes were delivered to the defendants, the money belonged to them and they could use it in any manner. The fact that they purchased the stock of and from their own corporation with the proceeds of the notes is not sufficient to hold the plaintiff bank

Plaintiffs alleged that they sold the promissory notes to the Health Clubs who thereafter sold the notes to the finance companies. However, the allegation of a "sale" does not confer standing if the context reveals that the "sale" of the notes was not the sale of a security.⁸¹

The *Joseph* court's due regard for the context-over-text language of the statute, and for the substance-over-form cases, is laudable. And the result can hardly be questioned since it cannot be doubted that the payees, as the alleged purchasers of securities, were not "investing" in the individual makers' notes.

The analysis in the recent case of *McClure v. First National Bank*,⁸² the second case contrary to *Movielab*, *MacAndrews* and *Lino*, is even more thorough. The plaintiff-maker of the notes in question owned half of the stock of a corporation. One of the defendants was the general manager of the corporation. The maker

liable under the undisputed facts as found and commented upon by the court.

There is no testimony to show that the plaintiff bank used the mails or any other instrument of interstate commerce in loaning the money.

In *Rosen v. Albern Color Research, Inc.* (E.D. Pa. 1963), 218 F. Supp. 473, the court stated at page 476:

"So far as we perceive, Congress did not undertake to regulate those transactions effected by direct person-to-person contact and negotiation. We are not here concerned with abstract considerations of power, but with actual manifestations of Congressional purpose and intent."

In affirming the district court's opinion, the Eighth Circuit indicated that the defendant-makers should have sued derivatively on behalf of Investors Thrift, the real purchaser of the stock of the agent's corporation. 422 F.2d at 228. But the court proceeded to agree with the lower court's conclusion that even if the agent had perpetrated a fraud, that fraud could not be imputed to the payee-bank; the claim was thus not properly against the payee. *Id.* at 231.

81. 336 F. Supp. at 313-14. The court then assumed *arguendo* that the makers were sellers of securities and found that even were this true, the undisclosed finance charges did not bring the case within the coverage of the 1934 Act. The court reasoned "that a reasonable investor (distinguished from a consumer debtor), in the exercise of due care, was not entitled to receive disclosure from the defendants that the note executed by him to the Health Club would thereafter be sold to a finance company." *Id.* at 315. This matter, the court concluded, was not the proper subject of a securities dispute, but rather should be viewed in the context of the claim based on the Truth-in-Lending Act.

The fact that the payees offered the club memberships to the general public did not play a role in the court's decision. But this is not surprising since the case was brought on the theory that the individual makers—not the payees—were the sellers of securities.

82. 352 F. Supp. 454 (N.D. Tex. 1973).

complained that the manager and an officer of the defendant bank had represented to her that the corporation needed to borrow 200,000 dollars from the bank in order to satisfy the corporation's business debts. The maker, relying on these representations, executed a note as the corporation's secretary. The manager also executed the note, which was made payable to the bank. The corporation, purportedly acting through the maker and the manager, executed and delivered a deed of trust to secure the note. The maker further alleged that, instead of the proceeds of the note being applied to the debts of the corporation, the 200,000 dollars was used to pay a debt owed by the manager to the bank, and that this misapplication was made with the full knowledge of all the defendants and pursuant to a fraud and conspiracy among them. Two and one-half years later the maker executed a separate collateral agreement pledging to the payee part of her stock in the corporation and in another corporation. The purpose of this later transaction was to secure a new note renewing and extending the original one. One and one-half years later the bank foreclosed on the corporation's property. The maker sued under Rule 10b-5.

The court squarely faced the issue whether the notes were "securities." In quoting the definition of that term the court recognized the context-over-text language of the statute. Citing *Beury* it noted that the definition could not be given an absolutely literal interpretation,

for to do so would be to place under the coverage of the Act many day-to-day loan transactions unrelated to the fraud-related abuses which Congress in 1934 was attempting to regulate.⁸³

The court cited the *Joseph* case and noted its reliance on *Vanderboom*, stating that in *Joseph* "the court held that the context of the transactions placed them outside the purview of the Act, since the statute defines a note as a security 'unless the context otherwise requires.'"⁸⁴ After quoting the Supreme Court in *Joiner*, the court concluded that substance must govern form, and that the only notes covered by the Act are those which are sold or traded for speculative or investment purposes in the same manner that stocks, bonds or debentures might be traded. The court held "that the transactions involved amount to little more than *ordinary commercial loans* not intended to be covered by the Act."⁸⁵

But the analysis did not stop there. The court also found it significant that, by passing the Truth-in-Lending Act, Congress had

83. *Id.* at 465.

84. *Id.* at 457.

85. *Id.* at 457-58 (emphasis added).

in effect determined that the 1934 Act is inapplicable to consumer loans, and by statutory implication, to commercial loans also. The need that Congress felt for a new statute to curb abuses in the consumer loan area precluded the notion that the lawmakers felt that such abuses could be reached under the 1934 Act. The court noted that

in 15 U.S.C. § 1603, a section within the Truth in Lending Act, Congress in setting forth transactions *outside* the purview of the Truth in Lending Act lists "credit transactions . . . for business or commercial purposes" and "transactions in securities" as *two different types of transactions*. Thus it is clear that most, if not all, ordinary commercial loans are not "securities" as defined by Congress as recently as 1968. Should Congress wish to place such commercial loans under federal regulation, it need only enact a statute similar in form to the Truth in Lending Act. It is not within the proper province of this Court to extend the scope of the Securities Exchange Act of 1934 beyond the point where Congress has chosen to act.⁸⁶

The *McClure* court then made the following statements, which accurately characterize what the results should have been in at least *MacAndrews* and *Lino*:

Thus these particular notes and transactions are not "securities" within the meaning of the Act. But even if these instruments complained of are securities, the transactions complained of must constitute the "purchase or sale" of such securities in order for liability to exist under the Act and in order for this Court to have jurisdiction over the present complaint. The Court holds that these transactions do not constitute the "purchase or sale" of securities and that for this additional reason plaintiff has not a cause of action under federal law.⁸⁷

This holding is in complete accord with the view that "one does not normally speak of the 'purchase' or 'sale' of a loan, whether or not it is evidenced by a note," as expressed in *SEC v. Fifth Avenue Coach Lines, Inc.*⁸⁸

The court in *McClure* then discussed and approved of the decisions in *Addison* and *Rekant*; it also agreed with the result in

86. *Id.* at 458 (emphasis in the original). The exemption from the Truth-in-Lending Act for securities transactions, referred to by the court, actually reads: "Transactions in securities or commodities accounts by a broker-dealer registered with the Securities and Exchange Commission." 15 U.S.C. § 1603(2) (1970). Obviously there are many securities transactions not falling within that exemption. Nevertheless, the truth of the implication drawn by the court from the separate treatment of this exemption and the exemption for "commercial" transactions cannot be doubted from a theoretical standpoint. See *infra* Part IV.

87. 352 F. Supp. at 458.

88. 289 F. Supp. 3, 38 (S.D.N.Y. 1968).

Movielab. The unimpeachability of the *Addison* case already has been discussed.⁸⁹ But this writer must disagree with the line which the *McClure* court drew between its situation and that presented in *Rekant*. The *McClure* court quite properly noted that in *Rekant* the corporation just as easily could have given stock or some other form of security instead of a note for the land it purchased. Indeed, the corporation *had* issued treasury shares to Desser as part of the purchase price. But the test derived from this fact by the *McClure* court cannot be accepted literally:

Thus where the transaction complained of is one where the issuance of a note rather than shares of stock is merely a technical difference in form, since defendant in exchange for the land *could have* taken an instrument more usually thought of as a security (such as additional shares of stock), there is jurisdiction under the Act.⁹⁰

Although this test is couched in substance-over-form language, its logic is faulty. Were it true that a note is a security whenever stock *could be* substituted for the note as payment for whatever is purchased by the note, then virtually every purchase of an asset by a corporation or loan by a shareholder to his corporation would involve a security. Many corporations purchase assets by giving notes to the vendor. Those corporations with many shares of stock in their treasuries, or with many shares of authorized but unissued stock, could indeed pay for such assets by issuing a few shares of stock instead of giving notes. But if instead the directors choose to retain the stock and give a note for the assets, can it seriously be contended that the transaction involves the selling of a security by the corporation? Similarly, a shareholder who has made a bona fide loan to his corporation without taking any evidence of the debt might later receive a note from the corporation. Does the note become a security merely because the corporation *could have* given the shareholder some form of redeemable security instead of the note? The logical extensions of the *McClure* court's line-drawing would be absurd.

But although the *McClure* court's test misses the mark, it is submitted that the court was pointing in the right direction. Were the test framed in terms of the nature of the transactions involved and whether stock actually in practice is given in such transactions, rather than being framed in terms of the form of payment and whether stock *could have been* given instead of what was given, then the test would provide a more discerning analysis. That is, a test of whether the transaction is of the kind in which stock often actually is given would not be inappropriate. Such a

89. See text accompanying notes 63-66 *supra*.

90. 352 F. Supp. at 459 (emphasis added).

test would embody many, if not all, of the more specific criteria suggested in Part IV of this article.

The court's test aside, *McClure's* approval of *Rekant's* determination that the note there involved was a security was unnecessary because that determination itself was unnecessary: the *Rekant* court could have reached the same result on a more satisfying basis by invoking the doctrine of pendent jurisdiction.⁹¹ The *McClure* court's approval of the *Movielab* result was probably better placed. The court by invoking its new test analogized the facts in *Movielab* to

the formal equivalent of the common merger acquisition whereby Corporation A purchases the assets of Corporation B and issues its own stock in payment. In *Movielab*, Corporation A merely issued a note in place of its stock.⁹²

The court's thrust, consistent with its test, was that stock *could have been* issued instead of the note. Had the *McClure* court applied the suggested test of whether the transaction was of the type wherein stock often is issued, then the same conclusion would have been reached by better reasoning. Hence, *Movielab* did involve a major asset acquisition closely analogous to a merger, and stock often is given in transactions of that nature. It is also significant that the *McClure* court rejected the view of the district court in *Movielab* that the *Fifth Avenue* case was totally inapplicable: *McClure* embraced the *Fifth Avenue* case as authority for its result despite the fact that the trial court in *Movielab* had dismissed the case as unpersuasive.⁹³

The *McClure* court finally reached the recent decision in *Sanders v. John Nuveen & Co.*,⁹⁴ and again it was on more solid ground. The court in *Sanders* held that certain short-term commercial paper, offered and sold to the general public, were securities despite the fact that the paper fell within the literal exemption of short-term notes from the definition of "security" in the 1934 Act.⁹⁵ Although the holding in *Sanders* was no doubt correct,⁹⁶ the *McClure* court correctly noted the overreaching found in *Sanders' dicta*:

91. See *supra* notes 58 and 59 and accompanying text.

92. 352 F. Supp. at 461.

93. *Id.* at 460.

94. 463 F.2d 1075 (7th Cir. 1972).

95. See *supra* note 5.

96. For an article urging the need for protection for investors in such short-term paper, see Comment, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362 (1972).

The *Sanders* court suggests indirectly that *all* notes having a maturity of more than nine months can be reached by the Act. With such reasoning this Court disagrees. *Sanders* does provide, however, a useful and cogent distinction between *two different kinds of notes: commercial (not covered by the Act, in the view of this Court) and investment (covered by the Act)*. The former is created "when a prospective borrower approaches a bank for a loan and gives his note in consideration for it." The latter is created when a person "seeks to invest his money and receives a note in return for it." . . . This Court holds that all notes in the latter category, regardless of maturity, are under the Act and that no notes in the former category having a maturity not exceeding nine months are under the Act. The instant case involves notes in the former category with maturity *greater* than nine months. In such a circumstance, this Court holds that jurisdiction under the Act must be determined by looking at the particular instruments involved in light of Congressional intent. After doing so, this Court concludes that the instant case must be dismissed.⁹⁷

Despite what this writer believes to be misplaced confidence in the *Rekant* case, and despite a slightly off-track test found in the opinion, the *McClure* decision taken as a whole provides a very thorough and satisfying analysis of the questions posed in this article.

The decisions in *Joseph* and *McClure* stand in stark relief against the bleak backdrop created by the reasoning in *Movielab*, *MacAndrews* and *Lino*. Only the former two cases recognized and gave effect to the principles of context-over-text and substance-over-form. That this was Congress' intent there can be no doubt.

III. THE RAMIFICATIONS OF AN AFFIRMATIVE ANSWER

Both procedural and substantive benefits inure to the plaintiff-maker if he is allowed to sue the payee in federal court under the 1934 Act.

A. SUBSTANTIVE RAMIFICATIONS

By affording the maker a right of action under the 1934 Act, an affirmative answer to the questions posed in this article relieves the federal courts of the obligations of the *Erie* doctrine, requiring the application of state substantive law in diversity cases.⁹⁸ The effects would be felt in at least four substantive areas: the elements of proof requisite for recovery, the liability of "controlling persons" under the 1934 Act, the security for expenses require-

97. 352 F. Supp. at 461 (emphasis added in the third sentence).

98. *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938).

ments of many states in derivative suits, and the application of the anti-waiver provision of the 1934 Act.

1. *Comparative Ease of Proof Under Rule 10b-5*

It has been noted already that it is easier to recover for securities fraud under Rule 10b-5 than under state law.⁹⁹ Specifically, the state blue-sky laws generally limit recovery to purchasers and thus would be inapplicable to suits by makers, as sellers, against payees, as purchasers.¹⁰⁰ This would relegate the maker in the state courts to the position of having to seek a common law remedy. If his cause of action is deceit, he will be faced with the sticky problems of proving the elements of *scienter*, justifiable reliance, and causation, which "have been difficult for plaintiffs in securities cases. And non-disclosure cases have rarely been actionable."¹⁰¹ Furthermore, while rescission "is the simplest of the non-statutory remedies,"¹⁰² because the maker avoids the barriers of causation and *scienter*, this remedy would be unavailable in many cases due to "rescission's own peculiar prerequisites of 'privity' between the parties and ability to restore . . . the *status quo*."¹⁰³

In contrast, the maker would have an easier time under Rule 10b-5. Although the elements of a Rule 10b-5 action somewhat resemble the elements of the common law actions, "the principle stretching by 10b-5 has been in recognizing non-disclosure and [virtually] dispensing with *scienter*."¹⁰⁴ In fact, "the courts have repeatedly said that the fraud provisions in the SEC acts . . . are not limited to circumstances which would give rise to a common law action for deceit."¹⁰⁵

Generally, some sort of *scienter* is required in a Rule 10b-5 action, but that element has been extremely watered-down by the federal courts.¹⁰⁶ The United States Court of Appeals for the Second Circuit in the celebrated *Texas Gulf Sulfur* case¹⁰⁷ flatly stated: "Whether the case before us is treated solely as an SEC enforcement proceeding or as a *private action*, proof of a specific intent to defraud is unnecessary."¹⁰⁸ At least four of the nine judges in

99. See *supra* note 1.

100. See 1 BROMBERG § 2.7(2).

101. 1 *id.* at § 2.7(1).

102. 3 Loss 1626.

103. *Id.* at 1627.

104. 2 BROMBERG § 8.1.

105. 3 Loss 1435.

106. See generally 6 *id.* at 3883-88.

107. SEC v. Texas Gulf Sulfur Co., 401 F.2d 833 (2d Cir. 1968).

108. *Id.* at 854 (emphasis added).

Texas Gulf Sulfur indicated that they would be willing to impose liability for negligence alone, and various other courts have held more squarely that negligence suffices for Rule 10b-5 liability.¹⁰⁹ Several other courts have even done away with the *scienter* element altogether, virtually imposing absolute liability for a violation of Rule 10b-5.¹¹⁰ And while some courts at common law have also relaxed the *scienter* requirement of fraud,¹¹¹ it would seem that the frequency and degree of relaxation in Rule 10b-5 cases provide a strong temptation for the plaintiff to choose a federal over a state forum.

Similarly, Rule 10b-5 cases have indicated a relaxation of the common law element of reliance—or perhaps more accurately, a blurring of that element with other fraud elements:

The courts regularly say that reliance by the defrauded party is necessary for recovery under Rule 10b-5. But closer inspection and analysis suggests that this is an oversimplification. More accurately, reliance and causation are no longer clearly distinguishable requirements *inter se* or relative to privity and materiality. Rather, they have become partially interchangeable and various combinations of one or two of them suffice in different situations.

In nondisclosure cases, reliance has little if any rational role. One court . . . indicated the need for active reliance on the defendant's silence, either because plaintiff had in mind the negative of the matter concealed, or because he deliberately trusted defendant's advice. But this notion was repudiated by the Second Circuit when it [said:] "The proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact." It is meaningless to talk of reliance in any more active sense in open-market situations. Moreover, the quoted view represents causation as much as anything else.¹¹²

Others have agreed that causation, rather than reliance, should be the focus of the inquiry in Rule 10b-5 actions,¹¹³ and although it can hardly be doubted that causation is an essential element in such actions,¹¹⁴ "it is far from clear how proximate the causation must be."¹¹⁵

Thus, it is clear that if ordinary commercial notes are indeed securities, the maker would have an easier time in proving the

109. See cases collected at 2 BROMBERG § 8.4(585) (1).

110. See 6 LOSS 3886-87; 2 BROMBERG § 8.4(630).

111. See 4 LOSS 1432; 6 *id.* at 3883.

112. 2 BROMBERG § 8.6(1) (footnotes omitted; quoting from *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir. 1965)).

113. See 6 LOSS 3878-80 (discussing the government's *amicus curiae* memorandum on the petition for a writ of *certiorari* in the *List* case).

114. See 6 *id.* at 3880-83.

115. 2 BROMBERG § 8.7(1).

elements of his action in the federal courts under Rule 10b-5 than in the state courts.

2. *Liability of 'Controlling Persons' Under the 1934 Act*

Section 20(a) of the 1934 Act¹¹⁶ imposes liability upon persons who are "in control" of violators of the Act, subject to the affirmative defense that the controlling person acted in good faith and did not induce the violation. Thus, in the context of the situation presented in this article, a maker of an ordinary commercial note *prima facie* could recover against the parent of a subsidiary payee, even if the corporate veil would not be pierced by state courts under the more conventional common law doctrine. This was precisely the case in *Lino*, where the maker sued the payee's parent corporation under Rule 10b-5.¹¹⁷ So yet another important substantive benefit is conferred upon the maker by allowing him to sue under the 1934 Act: the possibility of recovering against a person other than the payee who may be a more viable defendant than the payee himself.¹¹⁸

116. 15 U.S.C. § 78t(a) (1970):

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Although the 1934 Act itself does not define what a "controlling person" is, the concept would clearly include controlling shareholders, parent corporations and principals for the acts of their agents. Cf. SEC Reg. C, Rule 405(f), 17 C.F.R. § 230.405(f) (1972) (promulgated under the 1933 Act); ALI FED. SEC. CODE § 221 (Tent. Draft No. 1, 1972).

In one Rule 10b-5 action, a national brokerage firm was held liable for the acts of one of its wire correspondents. *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104 (W.D. Ark. 1949). In *Smith v. Bear*, 237 F.2d 79 (2d Cir. 1956), the partners of a New York broker-dealer firm were held liable as controlling persons for a California broker-dealer corporation's violations of Rule 10b-5. The president of the California corporation was a close friend of several of the New York partners, and much of the capital for the violator was supplied by wives and relatives of the partners. The New York firm paid for a direct wire between the two offices, but neither the partners, nor their wives and relatives, participated in the affairs of the violator. See generally 3 Loss 1808-11.

117. See *supra* text accompanying note 27.

118. Furthermore, the person who is controlled need not be made a defendant for the person in control to be liable. *DeMarco v. Edens*, 390 F.2d 836, 840 (2d Cir. 1968) (involving section 15 of the 1933

3. *Security for Expenses Requirements in Derivative Suits*

Recalling that the *Beury* and *Rekant* cases were stockholder derivative actions, it would not be surprising to find many other derivative suits arising where shareholders on behalf of corporate makers sue the payees of notes. Many states have statutes either requiring or allowing the courts to require the shareholder-plaintiff to post security for the defendants' expenses, including attorneys fees, in certain circumstances.¹¹⁹ Such statutes are substantive in that they create a new liability—indemnification by the plaintiff of the designated defendants' expenses of litigation under certain circumstances. These requirements are "insurmountable by many plaintiffs."¹²⁰ But the shareholder, suing derivatively on behalf of the corporate maker, would escape these obstacles in a

Act, 15 U.S.C. § 77o (1970), the 1933 Act counterpart of the 1934 Act § 20(a)).

An interesting problem would arise where, for example, a corporation in need of cash sells a note obtained by it through fraud to a controlling shareholder who participates in no way in the corporation's management. Assume that the shareholder purchases the note from the corporation for value, in good faith, and without notice of the fraud. He is thus a holder in due course under UNIFORM COMMERCIAL CODE § 3-302. (This assumes that the note is not a "security" under Code section 8-102 and therefore is not covered by Article 8 of the Code. For a discussion of the relation of Article 8 to the questions posed in this article, see *infra* Part IVD.) Upon the maker's default, the shareholder sues the maker in federal court, there being diversity of citizenship. The controlling state law is the Uniform Commercial Code. The maker not only sets up the fraud as a defense, but also counterclaims against the shareholder under Rule 10b-5. The maker's theory is that the note is a security which was purchased from him fraudulently and that the shareholder is liable under the 1934 Act, § 20(a) as a controlling person. Assume further that the fraud was not in the factum and is thus no defense as against a holder in due course under Code § 3-305. The practical result is that the shareholder must prove that he is a holder in due course not only to recover against the maker, but also to escape liability under § 20(a) by establishing his good faith defense. The 1934 Act, § 29(b), which voids contracts made in violation of the Act as regards the rights of certain persons, would not affect this result because by definition a holder in due course does not acquire his rights "with actual knowledge" of the fraud. 15 U.S.C. § 78cc(b) (1970).

119. See, e.g., CAL. CORP. CODE § 834(b) (West Supp. 1972); N.Y. BUS. CORP. LAW § 627 (McKinney Supp. 1972). Cf. MODEL BUSINESS CORPORATION ACT § 49 (1969) (providing for both security for expenses and indemnification upon judgment where no security was required).

120. 1 BROMBERG § 2.5(2).

Rule 10b-5 action.¹²¹ Thus, another substantive advantage is gained by being able to sue in the federal courts.

4. *The Anti-Waiver Provision of the 1934 Act*

Section 29(a) of the 1934 Act¹²² states:

Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.

In 1953 the Supreme Court construed the almost-identical language of section 14 of the 1933 Act¹²³ to void an agreement to arbitrate any future dispute that might arise between a brokerage firm and its customer.¹²⁴ No doubt the same construction would apply also to the 1934 Act's provision.¹²⁵ If the maker of an ordinary commercial note has a case under the 1934 Act, he could thus avoid an otherwise binding arbitration agreement.

B. PROCEDURAL RAMIFICATIONS

Not only does allowing a maker to bring a Rule 10b-5 action have the potential for drastically altering the substantive rights of the parties to the maker's advantage, but it also can aid him procedurally. The procedural benefits arise from both the 1934 Act itself and from the Federal Rules of Civil Procedure.

1. *The 1934 Act*

Section 27 of the 1934 Act,¹²⁶ which confers *exclusive* jurisdiction on the federal courts for claims arising from the Act,¹²⁷ also

121. The leading case is *McClure v. Borne Chem. Co.*, 292 F.2d 824 (3d Cir. 1961). It should be noted that § 11(e) of the 1933 Act, 15 U.S.C. § 77k(e) (1970), contains a security for expenses provision. But that section is inapplicable to the implied private rights of action under Rule 10b-5; since the maker could sue the payee only under the 1934 Act, he could not be compelled to post security by the 1933 Act. See 3 Loss 1836-42; 1 BROMBERG § 2.5(2); 2 *id.* at §§ 9.3, 11.7; *supra* note 4.

122. 15 U.S.C. § 78cc(a) (1970).

123. 15 U.S.C. § 77n (1970).

124. *Wilko v. Swan*, 346 U.S. 427 (1953).

125. *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178, 182-83 (2d Cir. 1966), *cert. denied*, 385 U.S. 817 (1966) ("Distinction would seem unlikely"). See generally 3 Loss 1811-17.

126. 15 U.S.C. § 78aa (1970).

127. It should be recalled that the federal courts probably would have pendent jurisdiction over the entire controversy between the maker and the payee even though certain of the issues might not be cog-

gives the plaintiff a wide choice of venues. The action may be brought in any district wherein "any act or transaction constituting the violation occurred" or "in the district where the defendant is found or is an inhabitant or transacts business."¹²⁸ This usually would allow the maker to sue in the district where he lives or where his business is located. Furthermore, "process in such cases may be served in any other district of which the defendant is an inhabitant or *wherever the defendant may be found*."¹²⁹ Such nationwide service of process could benefit greatly a maker who resides in a state with no long-arm statute or with a narrow long-arm statute. Thus, by suing in federal court the maker could obtain jurisdiction over a payee who might be immune from suit in the state courts because process could not be served on him.

2. *The Federal Rules of Civil Procedure*

It is well recognized that the procedural rules which operate in the federal courts are more liberal than the rules in many states in such areas as pleading and joinder. But an even more important benefit could inure to the maker under the Federal Rules: the availability of the class action, a device which has proved to be "especially useful in cases involving securities frauds."¹³⁰ This device, unavailable altogether or available only to a more limited extent in many states, has already been invoked by makers of ordinary commercial notes attempting to sue payees under Rule 10b-5.¹³¹ And it is a fact of legal life that the threat of having to defend a costly class action has coerced many defendants into settlements favorable to the proposed representatives of the class. The proper use and unfortunate abuse of the class action device thus also would be available to makers of ordinary commercial notes were they allowed to sue payees in the federal courts under the 1934 Act.

It cannot be doubted that the substantive and procedural advantages of a federal forum would lead many makers of ordinary commercial notes to choose Rule 10b-5 as the vehicle by which to air their cases. The ramifications of the affirmative answers given

nizable on their own in the federal courts. See *supra* notes 58 and 59 and accompanying text.

128. 15 U.S.C. § 78aa (1970).

129. *Id.* (emphasis added).

130. C. WRIGHT, LAW OF FEDERAL COURTS 312 (2d ed. 1970).

131. *Joseph v. Norman's Health Club, Inc.*, 336 F. Supp. 307 (E.D. Mo. 1971) (summary judgment granted against the makers on the securities issue; class action held maintainable on the remaining claim based on the Truth-in-Lending Act).

to the issues presented in this article by the *Movielab*, *MacAndrews* and *Lino* courts would thus not remain isolated. And while "flood of litigation" arguments should never be used to deprive persons of rights which they are intended to have, the federal courts should not open their doors to the makers of ordinary commercial notes when it is recognized that the federal securities laws exist for the protection of *investors*.¹³²

IV. SUGGESTED CRITERIA

It may be easier to conclude that ordinary commercial notes should not be treated as securities, while investment notes should be so treated, than it is to determine just how that distinction is to be made in any particular case. The courts must resolve the issue by closely analyzing the facts in each case, always keeping the principles of context-over-text and substance-over-form firmly fixed before them as the overriding guide. The list of suggestions that follows is by no means exhaustive. Only one of the factors discussed should be determinative; none of the others is intended to be controlling. Many of the factors present inquiries into matters of degree.

A. COMMON EXPECTATIONS

The Supreme Court twice has stated the test of whether a particular instrument is a security as: "*What character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect.*"¹³³ This test itself is of no concrete help. Rather, it merely puts the inquiry into the proper frame of reference: How would reasonable businessmen in the commercial world characterize the instrument? But as a generalized statement of the issue the test is useful. It serves here as the starting point for a list of factors which seek to give life to that test.

B. USE OF THE PROCEEDS¹³⁴

The analysis suggested by this factor follows a two-step approach. The first inquiry is whether the maker of the note used

132. See *supra* Part IIB2.

133. *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 211 (1967), quoting *SEC v. Joiner Leasing Corp.*, 320 U.S. 344, 352-53 (1943) (emphasis added).

134. This factor is suggested by the court's discussion of the Truth-in-Lending Act in *McClure v. First Nat'l Bank*, 352 F. Supp. 454, 458 (N.D. Tex. 1973).

the proceeds to purchase consumer goods¹³⁵ or services as opposed to using the funds for an essentially business purpose. If the answer to this inquiry is that the note was given in a consumer transaction, then that determination should conclusively establish that the note is not a security for several reasons. Most important is the fact, noted by the *McClure* court,¹³⁶ that Congress has provided an entirely separate regulatory scheme for the protection of consumers, excluding from that scheme commercial and securities transactions. Also, the makers and payees of consumer notes are well protected under the Uniform Commercial Code. The payee is protected by Article 9 of the Code, and particularly by section 9-302(1) (d), which provides that a financing statement need not be filed to perfect a purchase money security interest in most consumer goods.¹³⁷ The rights and liabilities of the maker and the payee are also covered by Article 3 of the Code on commercial paper. The consumer-maker is further protected by the warranties provisions of Article 2 on sales.¹³⁸ There is thus no doubt that the 1934 Act is not the proper basis for a suit by a consumer-maker; it would be absurd to treat his note as a security.

On the other hand, if it is determined that the proceeds of the note were used for essentially business purposes, then a second inquiry is in order: whether the proceeds were used to finance the purchase of particular business goods or services as opposed to using the funds for the general financing of the maker's enterprise.¹³⁹ The use of proceeds to buy specific assets or services is more char-

135. The Truth-in-Lending Act, 15 U.S.C. § 1602(h) (1970), defines the word "consumer" in terms adequate for this purpose:

The adjective "consumer," used with reference to a credit transaction, characterizes the transaction as one in which the party to whom credit is offered or extended is a natural person, and the money, property, or services which are the subject of the transaction are primarily for personal, family, household, or agricultural purposes.

"Consumer goods" are defined in UNIFORM COMMERCIAL CODE § 9-109(1) as those "used or bought for use primarily for personal, family, or house-hold purposes."

136. 352 F. Supp. at 458 (discussing the mutually exclusive coverage of the 1934 Act and the Truth-in-Lending Act).

137. UNIFORM COMMERCIAL CODE § 9-302(1) (d):

(1) A financing statement must be filed to perfect all security interests except the following:

(d) a purchase money security interest in consumer goods; but filing is required for a fixture . . . or for a motor vehicle required to be licensed.

138. See UNIFORM COMMERCIAL CODE §§ 2-312 to -315.

139. This further inquiry is suggested by *McClure's* discussion of the separate Truth-in-Lending Act exemptions for commercial and securities transactions. 352 F. Supp. at 458.

acteristic of an ordinary commercial note, while the employment of funds for general financing is more indicative of an investment note. The inquiry here is clearly into a matter of degree: for example, the business maker who uses a note to purchase a large piece of machinery which comprises all or most of the tangible assets of his enterprise may well be issuing an investment note. The transaction should be subjected to the remaining criteria suggested.¹⁴⁰

An excellent example of a case where the use-of-proceeds factor was an essential element of the context is *Joseph v. Norman's Health Club*.¹⁴¹ The plaintiffs' notes were given solely for consumer services represented by a membership in a health club. The payees were not "investing" in the consumers' notes in any sense of the word. And while the court never mentioned the consumer nature of the transactions, it is clear that this factor was lurking somewhere beneath the court's context-over-text approach.

C. RELYING ON THE EFFORTS OF OTHERS: RISK, RIGHTS
REPAYMENT, RECOURSE

The Supreme Court in *SEC v. W.J. Howey Co.*,¹⁴² speaking of

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140. An indicia somewhat related to the use of the proceeds is the business organization of the maker. It would be more unusual to characterize the note of an individual proprietor or a partnership as a security than it would to characterize a corporation's note as an investment instrument. But this indicator, though perhaps a legitimate factor, is extremely unreliable, since it is clear that not every corporate note is a security. See *SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3, 38 (S.D.N.Y. 1968).

Similarly, the organization of a business payee is an unreliable factor. On the other hand, the character and relative size of the payee's business *might* be the subject of a legitimate inquiry. For example, it would often be difficult to envision a corporation's giving of a note or notes to an underwriting or investment banking firm as an ordinary commercial transaction. Beyond that, however, it would be difficult to classify the transaction as investment or commercial by a mere reference to the fact that the payee is a manufacturer, wholesaler, service company, or commercial bank.

The size of the payee's business relative to the size of the maker's could play an important role in the analysis, though. It has already been stated that the maker who gives his note in exchange for an asset which constitutes all or most of the tangible property of his business might be viewed as selling a security since essentially he is engaging in the general financing of his enterprise. On the other hand, if the payee is a large manufacturer which produces and sells thousands of items such as the one for which the note was given, it could hardly be said that the manufacturer is "investing" in the maker's business.

141. 336 F. Supp. 307 (E.D. Mo. 1971).

142. 328 U.S. 293 (1946).

"investment contracts" under the 1933 Act, set forth a test in terms of "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."¹⁴³ Again the Court's test is but a generalized statement of the issue. The test even has logical inconsistencies since in part it defines an "investment contract" as involving an "investment of money," which is but to include that which is being defined in its own definition. Furthermore, the test could never be taken to its logical extreme, since it is quite proper to say that even in the clearest of consumer credit transactions, the person extending credit expects his profits, in the form of interest, to come solely from the efforts of the consumer to earn enough money to pay for the interest (and principal). The same is true for the commercial creditor: he, too, expects his profits to come solely from the earnings of his business debtor. Besides, a person who purchases stock of a close corporation of which he is the general manager is surely "investing" despite the fact that he is largely relying on his own efforts to produce the profits of the enterprise.

Nevertheless, the test is still conceptually useful in any situation when it is necessary to determine whether a particular instrument is a security. Its use derives from two sources. First, the court was defining an "investment contract," a phrase which could serve as a general description of any of the specific instruments included in the federal definitions of "security." Second, the test serves to focus the inquiry on several characteristics incident to the concept of relying on the efforts of others. These characteristics in the context of notes are organized in terms of the risks incurred by the payee, the rights given to the payee, and the contemplated methods of repayment and recourse.

1. Risk

Professor Coffey of Case Western Reserve University, in seeking to define a "security" with reference to economic realities, stated, "It is a major contention of this [author] that risk to initial investment, though not determinative, is the single most important characteristic which distinguishes a security from the universe of other transactions."¹⁴⁴ Again the word "investment" crops up in an explanation of a definition of that which is an investment, for

143. *Id.* at 301.

144. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367, 375 (1967). Professor Coffey's definition of a "security" is found *id.* at 377 (emphasis added):

A "security" is:

(1) A transaction in which

it has been seen that the word "investment" is merely an aphorism for the term "security" as used in the 1933 and 1934 Acts.¹⁴⁵ A more substantial difficulty with the position that risk is the single most important factor is that risk is essentially a function of the financial standing of the obligor, rather than necessarily being a function of the transaction itself. Many instruments which are clearly securities are virtually riskless while other transactions which just as clearly do not involve securities are fraught with a high degree of risk. For example, debentures offered publicly by an old, well-established, "blue-chip" corporation hardly should be characterized as securities by virtue of the risk involved in their purchase: such risk is probably non-existent, but the debentures would be securities nonetheless. On the other hand, a note given by a young, financially-unstable corporation merely in exchange for an automobile, for example, possibly could involve a great amount of risk. Yet under the criteria suggested in this article, as well as in the views of almost any reasonable businessman or lawyer, such a note should not be deemed to be a security. Nevertheless, while risk to the initial outlay should not be viewed as the "single most important" factor, an inquiry into the risk aspects of a transaction allegedly involving securities is not inappropriate since risk is to some extent related to the degree to which one relies on the efforts of others.

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- (2) a person ("buyer") furnishes value ("initial value") to another ("seller") and
 - (3) *a portion of initial value is subjected to the risks of an enterprise, it being sufficient if—*
 - (a) *part of initial value is furnished for a proprietary interest in, or debt-holder claim against, the enterprise, or*
 - (b) *any property received by the buyer is committed to use by the enterprise, even though the buyer retains specific ownership of such property, or*
 - (c) *part of initial value is furnished for property whose present value is determined by taking into account the anticipated but unrealized success of the enterprise, even though the buyer has no legal relationship with the enterprise; and*
 - (4) *at the time of the transaction, the buyer is not familiar with the operations of the enterprise or does not receive the right to participate in the management of the enterprise; and*
 - (5) *the furnishing of initial value is induced by the seller's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above initial value, will accrue to the buyer as a result of the operation of the enterprise.*

145. See *supra* Part IIB2.

Referring specifically to the "debt-holder" portion of his definition of a "security,"¹⁴⁶ Professor Coffey explained:

Here the buyer relinquishes specific ownership of his initial investment and takes in return a creditor's intangible claim against the enterprise. The initial investment merges into the general enterprise capital, just as it does in the proprietary interest arrangement. Unlike the buyer of a percentage share, however, the purchaser does not agree to bear the losses of the enterprise pro rata, and his value is usually to be returned according to a schedule, whether or not the enterprise has suffered losses.

In some cases, there is sufficient junior percentage-share-type investment to absorb losses before they erode the enterprise assets to a point where the creditor's original investment is jeopardized. Holders of debt may not always be so fortunate, however, since not all enterprises are financially structured to include percentage-share junior investment, and those which are may provide only a thin cushion for creditors.

In short, the original value furnished in a debt transaction may be somewhat more protected from the ravages of enterprise failure than is the value furnished for a proprietary interest. A secured debt is merely farther removed from the front lines of risk, for failure of the enterprise is as likely to take its toll of the property securing the debt as it is the rest of the assets.

It seems safe to say, then, that there is a significant degree of risk to initial value furnished in exchange for debt obligations.¹⁴⁷

It is submitted that by including in his definition of a "security" all "debt-holder claims"¹⁴⁸ which fit the description set forth in this passage, Professor Coffey takes in too many fish. Whenever a person extends credit to another, be it in a consumer, commercial or investment sense, he becomes a debt-holder subject to the risks of losing his initial value. The ultimate risk is bankruptcy of the debtor.

In fact, the generalities of Coffey's entire discussion of risk are of little help where the court must draw the often-fine line between commercial and investment transactions. Indeed, the professor recognizes this problem in a later discussion of "the isolated and private transaction."¹⁴⁹ But his response is disappointing. He first notes that such transactions usually to some degree possess all of the necessary economic attributes of a security. He observes:

As the statutes are presently written, the isolated nature of a transaction and the element of privateness are generally relevant only to the issue of whether a transaction should be exempt from registration. . . . If a transaction is isolated and private, the danger

146. See *supra* note 144.

147. 18 W. RES. L. REV. at 385-86 (footnotes omitted).

148. See *supra* note 144.

149. 18 W. RES. L. REV. at 407-11.

of fraud is reduced both quantitatively and qualitatively; in other words, these elements are factors which mitigate, but do not eliminate, the probability of fraud.¹⁵⁰

With special reference to promissory notes and the exclusion of short-term notes from the 1934 Act definition of a "security,"¹⁵¹ the professor invokes *expressio unius est exclusio alterius* reasoning to conclude "that factors in mitigation of the probability of fraud are relevant to the issue of exemption [from registration]—not to the issue of security status."¹⁵² He summarizes with the belief that there is little justification in the statutes for excluding a transaction from "security" classification merely because of its private and isolated character.¹⁵³

But he is still troubled by the isolated and private purchase-money note situation. He recognizes the argument that some notes just were not intended to be covered by the fraud provisions and states that "the policy of the argument would probably be one of judicial and administrative economy."¹⁵⁴ With all deference, it would seem that the policy of the argument rests with the theoretical impossibility of treating all notes as securities. Totally ignoring the context-over-text language of the statute, Professor Coffey concludes that the only way out of the predicament is by amendment to the statute.¹⁵⁵

Despite the theoretical and practical difficulties of Coffey's analysis, this writer believes that risk factors are indeed a legitimate subject of inquiry in the determination of whether a particular note is a security. Again the question is one of degree, though. The following three sub-factors seek to aid in measuring that degree.

2. Rights Given to the Payee

One measure of the degree of risk involved in a note transaction derives from the beliefs of the parties. The maker, recognizing the risk to a large outlay by the payee, may confer upon the payee certain rights usually incidental to an investment interest. Such rights may include the right to vote and/or inspect the books and records of a corporate maker.¹⁵⁶ The corporate maker may

150. *Id.* at 408.

151. *See supra* note 5.

152. 18 W. RES. L. REV. at 408.

153. *Id.* at 409.

154. *Id.*

155. *Id.* at 411.

156. Cf. CAL. CORP. CODE § 306 (West 1955). In *Tcherepnin v. Knight*, 389 U.S. 332, 337 (1967), it was noted that the instruments under consideration gave voting rights to their holders. The instruments, it will be recalled, were held to be securities.

also be prevented from paying dividends, changing the capital or operational structure of the company, or engaging in acquisitions or spin-offs until the notes are paid. Other rights of control over the operations and affairs of the maker may be given to the payee. If such rights are given to the payee, then this may be a strong, though probably not controlling, indication that the notes were treated as securities by the parties themselves.

On the other hand, the taking of such rights by the payee merely might reflect a disparity in bargaining position between it and the maker, and an exercise of such superior power by the payee indeed may be totally unrelated to the risk attendant to the transaction. And even if the reason for the payee's assertion of its greater bargaining position is somehow related to risk, then still that relationship may be disproportionate to the degree of risk involved. For example, even a financially stable maker may be forced to grant such rights to a more powerful payee if the payee has any fear that the maker's success will lead it into acquisitions or changes in its capital or operational structure which could subject the payee's initial outlay to some greater degree of risk. In fact, if the payee is powerful enough, it may require that such rights be given to it in all transactions, whoever the maker is and regardless of whether or not its fears are justified. As the variables increase, the focus of the inquiry shifts away from whether the transaction involves securities, and at some point it may be necessary to conclude that the factor of rights given to the payee is not at all relevant.

3. *Methods of Repayment*

The manner in which the notes are to be paid may also aid in the determination of whether or not the notes are securities. If the notes are payable in full on a definite date, or are payable in fixed installments, then the indication is that the payee is no more than a general creditor, although this aspect of the factor may not be particularly reliable. On the other hand, a strong indicia that the notes are securities would be a scheme whereby repayment is contingent on the maker's profits or is payable only out of the maker's production.¹⁵⁷ Thus, again, the terms of the transaction fixed by the parties themselves may be factors of the risk involved; such terms are properly put in the balance when determining whether the notes are securities.

157. Cf. *Schamber v. Aaberg*, 186 F. Supp. 52 (D. Colo. 1960) (\$50,000 promissory note payable solely out of maker's production).

4. *Methods of Recourse*

The nature of the collateral security for the notes, if any, may also be a factor. If the security is limited to the asset purchased by the maker, then the inference is that the notes were not used to generally finance the maker's enterprise. In contrast, if the collateral extends beyond that which was purchased, a more proprietary-type interest may be indicated. And if the notes are totally unsecured, then contrary conclusions may be drawn: the lack of collateral security may reflect an equity type of interest, or it may reflect instead a general creditor's interest. The size of the transaction¹⁵⁸ may aid in determining which polar extreme is indicated because if the payee is supplying a substantial portion of the maker's funds or assets, then perhaps more of an equity type of interest is reflected. On the other hand, the chosen method of recourse merely may reflect a disparity in bargaining power, as with the factor of the rights given to the payee.

In summary, from the Supreme Court's general "relying on the efforts of others" test there may be derived the relevant factors of risk, rights given to the payee, and methods of repayment and recourse. The reliability of these factors will vary greatly with the facts of each case. The inquiries suggested here vividly illustrate the difficulty of the analysis, the varying degrees of relevance of the factors involved, and the need to examine all the facts of the transaction as an integrated whole.

D. THE NUMBERS GAMES

Although it is extremely difficult to draw lines by reference to the number of notes issued, the number of payees to whom they were issued, and the dollar amount of the transaction, these too are legitimate factors. They are also extremely interrelated factors. That the number of notes issued is relevant is indicated by two sources. The first is the previously-discussed case of *SEC v. Fifth Avenue Coach Lines, Inc.*¹⁵⁹ The court, in holding that certain loans and notes were not securities, distinguished "the 'personal loan' cases relied upon by plaintiff" on the basis that those cases involved "a whole series of notes, not one or two."¹⁶⁰ Second, in similar language the Uniform Commercial Code's definition of an investment security states that "a 'security' is an instrument which . . . is either one of a class or series or by its terms is divis-

158. See *infra* Part IVD.

159. 289 F. Supp. 3 (S.D.N.Y. 1968).

160. *Id.* at 38.

ible into a class or series of instruments.”¹⁶¹ The conclusion is that where a series of notes is involved, they probably are securities; where only a few are involved, they *may* not be.

The number-of-notes factor is closely related to an even more well-recognized indicia: the number of payees involved. If there is merely one isolated note payable to one person, then the indication is that it is probably not a security. This would be the case where all negotiations take place between two persons only, or perhaps among three, if a bank is used to provide the cash for a purchase of a commodity by one of the persons from the other. On the other hand, where many notes are given by the maker to many persons, then it is more probable that securities, and possibly a public offering of them, are involved. It is thus not surprising to recall that most of the important cases holding notes to be securities involved a public offering of sorts.¹⁶²

161. UNIFORM COMMERCIAL CODE § 8-102. The entire definition of a security in the Code is as follows:

§ 8-102. Definitions and Index of Definitions

(1) In this Article unless the context otherwise requires

(a) A “security” is an instrument which

- (i) is issued in bearer or registered form; and
- (ii) is of a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment; and
- (iii) is either one of a class or series or by its terms is divisible into a class or series of instruments; and
- (iv) evidences a share, participation or other interest in property or in an enterprise or evidences an obligation of the issuer.

Note especially the introductory “context-over-text” language. The Official Comment to Code § 8-101 is careful to note that Article 8 “is neither a Blue Sky Law nor a corporation code. It may be likened rather to a negotiable instruments law dealing with securities.” Furthermore, the Official Comment to § 8-102 itself recognizes that obviously there may be securities which fall under the federal definition but which do not fall within the Code definition. Nevertheless, it is clear that if an instrument is a security under the Code, it is also a security under the 1934 Act. The Code definition is also useful as an indication of “what character the instrument is given in commerce.” *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 211 (1967), quoting *SEC v. Joiner Leasing Corp.*, 320 U.S. 344, 352-53 (1943).

The majority and dissenting opinions in the Seventh Circuit’s decision in the *Tcherepnin* case both noted the relation between the Code, the 1934 Act and the instruments in question. *Tcherepnin v. Knight*, 371 F.2d 374, 376 (7th Cir. 1967) (dissenting opinion discussion at 383), *rev’d*, 389 U.S. 332.

162. *E.g.*, *Sanders v. John Nuveen & Co.*, 463 F.2d 1075 (7th Cir. 1972); *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1953); *SEC v. Addison*,

Another related, though perhaps more unreliable, factor is the dollar amount of the transactions involved. In its very brief affirmation of the district court's opinion in *Movielab*, the Second Circuit announced the principle:

In this court, appellants strenuously urge that claims of fraud in connection with the issuance of notes in every private loan transaction cannot be within the scope of the Securities Exchange Act of 1934. Otherwise, they say, federal jurisdiction could be invoked in connection with the issuance of any check or note no matter how small the transaction so long as some instrumentality of interstate commerce was used. *We need not deal with that hypothetical situation.* Appellants concede that the definition of security in section 3(a)(10) of the Act, 15 U.S.C. § 78c(a)(10), states that "The term 'security' means any note . . ." and therefore includes some notes at the very least. *Clearly then, notes issued by one publicly owned company to another publicly owned company for \$10,500,000, payable over a period of 20 years, in exchange for the assets of the latter easily fall within the purview of the Act, which we have only recently been directed to construe "flexibly, not technically and restrictively."*¹⁶³

This passage indicates that the appellate court in *Movielab* to some extent was concerned with the nature and substance of the transaction, rather than merely with a literal reading of the statutory definition of "security."¹⁶⁴ If *Movielab* is viewed in fact as involv-

194 F. Supp. 709 (N.D. Tex. 1961); *SEC v. Vanco, Inc.*, 252 F. Supp. 943 (D.N.J. 1958).

163. *Movielab, Inc. v. Berkey Photo, Inc.*, 452 F.2d 662, 663 (2d Cir. 1971), *aff'd* 321 F. Supp. 806 (S.D.N.Y. 1970) (emphasis added). The Second Circuit's decision is the first federal appellate opinion in a case where the maker of a note sued the payee on the theory that the payee had fraudulently purchased securities.
164. The Second Circuit recently suggested the correctness of this conclusion in *Zeller v. Bogue Elec. Mfg. Corp.*, [1973 Current] CCH FED. SEC. L. REP. ¶ 93,903 (2d Cir. March 22, 1973). *Zeller* was a derivative suit on behalf of a subsidiary against its parent for allegedly forcing the subsidiary to loan \$315,310 to the parent at inadequate interest rates. The loans at first were in the form of open-account advances, but were later evidenced by an 8% demand note. The claim for relief was based on both the 1933 and 1934 Acts on the theory that the subsidiary was a defrauded purchaser of a security, namely the note. The parent had paid the amount of the advances together with interest, but the suing stockholder claimed consequential damages on behalf of the subsidiary. The district court dismissed the action on the theory that the 1934 Act, § 28(a), 15 U.S.C. § 78bb(a) (1970), which limits a plaintiff's recovery to "actual damages," does not permit the recovery of consequential damages. As a preliminary matter, the court of appeals rejected the parent's claim that no security was involved; the court held that the demand note was a security. During the course of its discussion on this point, the Second Circuit stated:

It does not follow, however, that every transaction with-

ing a major asset acquisition, then such a transaction often is effectuated by issuing securities, and it is not unlikely that the notes in *Movielab* properly were treated as securities.

Still, it is not altogether clear how significant a role the dollar amount of the transaction *should* play. For example, the amount of the note in *McClure* was 200,000 dollars; in *Fifth Avenue* the notes and loans ranged from 85,000 dollars to 1,800,000 dollars. But the amount of the notes in neither of these cases led to a holding that they were securities. Is the line to be drawn somewhere between 10,500,000 dollars (*Movielab*) and 1,800,000 dollars (*Fifth Avenue*)? Or is it just that *McClure* and *Fifth Avenue* recognized what the court in *Movielab* did not: that large corporations deal in great sums of money, and that fact of itself does not make those dealings transactions in securities, even where notes are involved. This writer believes that the second alternative is the better one, and would prefer that the dollar amount of the notes be recognized, if at all, as a somewhat unreliable factor.

The "numbers game" leads to three conclusions: first, the number of notes issued is relevant; second, the number of payees involved and the extent of the offering is very significant; and third, the dollar amount of the transaction may be treated as a factor, but only as a rather unreliable one.

E. TIME ELEMENTS

A factor similar to the "numbers game" is the time element factor. This factor presents a two-step approach. First, are the notes

in the introductory clause of § 10, which involves promissory notes, whether of 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.* See *Movielab, Inc. v. Berkey Photo, Inc.*, 452 F.2d 662 (2d Cir. 1971).

CCH FED. SEC. L. REP. ¶ 93,903 at 93,621 (emphasis added). The appellate court, without further analysis, proceeded to find that the subsidiary "stood in the position of an investor, although perhaps an involuntary one, with respect to" the parent, *id.*, a conclusion of doubtful validity in view of the criteria suggested in this article.

The *Zeller* case is significant because the court, while correctly recognizing the purpose of the statute, begged the question by asserting its conclusion without saying *why* the subsidiary should have been treated as an investor and thus as a purchaser of a security. The Second Circuit's decision reaffirms not only its willingness to accept the principles underlying the Act as indicated in *Movielab*, but also the great need to analyze the question in terms of *some* standards or criteria, rather than merely stating a bald conclusion. The court went on to hold that consequential damages are recoverable. See *infra* note 172.

payable at a fixed time or on demand by the payee?¹⁶⁵ If they are fixed-time notes, then they may or may not be securities. But it is highly unlikely that notes payable on the demand of the payee or holder would be securities: when a "demand" provision is embodied in a *security*, it is generally a demand on the part of the issuer, not the holder, as with securities subject to call or redemption provisions at the option of the issuer.¹⁶⁶

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165. A related inquiry would be whether the notes are payable to order or bearer. Securities under the Uniform Commercial Code must, according to § 8-102(1) (a) (i), be "issued in bearer or registered form." See *supra* note 161. But obviously order notes can be securities under the 1934 Act.

Similarly, whether or not the notes are transferrable or negotiable may be relevant under the Code, but not under the Exchange Act, except to the extent that non-transferrable or non-negotiable notes may indicate closer person-to-person dealings between the parties. Such situations would obviate the need to sue on the instruments themselves; suit could be maintained on the underlying obligation, such as a contract to purchase an asset.

166. An analogous problem arises in the tax area when a taxpayer transfers appreciated property to a corporation in return for corporate notes. Here the taxpayer, if he is a controlling shareholder, will try to assert that the notes are securities so as to escape taxation on the appreciation under INT. REV. CODE OF 1954 § 351. Section 351 provides essentially that no gain or loss shall be recognized when property is transferred to a corporation in exchange for its stock or securities if the transferor controls the corporation after the transfer. Thus the courts in another context must determine whether certain notes are securities. It is clear that demand notes are not. See *Turner v. Commissioner*, 303 F.2d 94 (4th Cir. 1964) ("notice of indebtedness" against which payee could withdraw funds "at any time" not a security.).

The Second Circuit in the *Zeller* case, see *supra* note 164, held that the demand note there involved was a security. At first blush this holding is directly contrary to the position taken in the text and by the *Turner* case in the tax area that demand notes probably are not securities. However, the *Zeller* court's primary discussion was addressed to the question of whether demand notes fall within the exception to the statutory definition of securities for notes having maturities of less than nine months. See *supra* note 5. Expressly leaving the question open, the court concluded that the particular note involved could not qualify for the exception even if some demand paper could so qualify. Since the question was thus whether the note fell within the general definition of securities, rather than within the narrow exception to that definition, the court, citing *Movielab*, recognized that the mere fact that notes were involved did not necessarily bring the case within Rule 10b-5. CCH FED. SEC. L. REP. ¶ 93,903 at 93,621; see *supra* note 164. This recognition necessarily implies that not all notes should be treated as securities. The court without further discussion then held that the note involved *should* be treated as a security. Thus, the court did not discuss the demand nature of the note except with respect to the question of

If the note is payable on a fixed date or at fixed intervals, then the further inquiry should be as to the length of time between issuance and maturity. This factor is, of course, another matter of degree. But it would not be unusual for the courts to attempt to draw such time lines with respect to notes.¹⁶⁷ Notes with relatively long maturities—for example, thirty or forty years—might truly reflect a proprietary interest.

It is not clear how much emphasis was placed by the Second Circuit on the twenty-year term of the notes in *Movielab*. The term was mentioned in the passage quoted above,¹⁶⁸ and this may serve as a further indication that the appellate court was analyzing the case in terms of substance over form and that the result in the case may have been appropriate.

F. CHARACTERIZATION OF THE NOTES ON THE RELEVANT FINANCIAL STATEMENTS

The last factor suggested inquires into how the parties characterize the notes on their financial statements. A characterization

whether demand notes fall within the short-term commercial paper exception to the definition of securities—no mention was made of the demand nature of the note as affecting the question of whether the instrument fell within the general definition of securities. Furthermore, the court itself indicated that perhaps the note involved should not even have been viewed as a demand note since “the maker of the note [the parent] could prevent any demand by the holder [the subsidiary] and the note was outstanding for ten months.” *Id.* at 93,620.

167. Again in the § 351 area of tax law, it has been observed that “the length of time to maturity usually is regarded as the most important single earmark. Notes with a five-year term or less rarely seem able to qualify as ‘securities,’ while a term of ten years or more ordinarily is sufficient.” B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 3.04 (3d ed. 1971) (note especially cases cited in footnote 17).

While perhaps more certainty is needed in the tax law than in the federal securities law area, it seems that such mechanical tests should not control. This has been held to be true by the Tax Court itself. *Camp Wolters Enterprises, Inc. v. Commissioner*, 22 T.C. 737, 750-51 (1955), *aff’d*, 230 F.2d 555 (5th Cir. 1956), *cert. denied*, 352 U.S. 826 (1956). Nevertheless, the time factor remains a legitimate area of inquiry under both the tax law and the 1934 Act.

It is submitted, however, that a ten-year rule of thumb in the securities area would be highly inappropriate: the financing of an expensive machine which comprises but a small portion of a large corporate maker's assets may well involve a note with an over-ten-year maturity. Such a purchase money note probably should not be treated as a security under the 1934 Act.

168. 452 F.2d at 663.

indicating that the parties believed that the notes were securities should be given some weight. For example, the court in *Sanders v. John Nuveen & Co.*,¹⁶⁹ holding that the short-term notes involved were securities, observed that the issuer characterized the notes, which were offered to the public, as "short term open market paper" in its financial statements,¹⁷⁰ thus indicating that the issuer recognized the investment nature of the notes.

In summary, when courts are faced with the determination of whether particular notes are securities, they must embark upon a substance-over-form approach. The factors suggested here are intended to aid in that determination by helping to identify just what the context of the transaction is: commercial or investment.

V. CONCLUSION

The maker of an ordinary commercial note, as opposed to an investment note, should not be able to sue the payee in federal courts under the 1934 Act. The five cases which have squarely presented the issue are split. Three of them followed a plain meaning-literal language approach and allowed the maker to sue, disregarding the context-over-text language of the 1934 Act itself, the legislative history of the federal securities laws, and the import of the relevant case law. The other two followed a substance-over-form approach and refused to allow the maker to sue in the federal courts. It is submitted that the latter two cases were correct and that the reasoning of the former three was erroneous. Furthermore, the results in at least two of the three cases answering affirmatively the questions posed in this article were incorrect.

The ramifications of allowing the maker to state a claim under the 1934 Act are sweeping: not only procedural rights, but indeed substantive rights as well, are significantly altered by allowing the suit. When faced with such a problem, the courts must examine the facts with the principle of context-over-text firmly in mind. Several factors are suggested to aid in the court's determination.

Throughout this article it has been suggested that the district court's reasoning in the *Movielab* case was highly erroneous because it would allow the maker of an ordinary commercial note to sue its payee in the federal courts, but that the result of the case was perhaps correct because the notes involved may have been investment notes.¹⁷¹ It is appropriate, therefore, to attempt to

169. 463 F.2d 1075 (7th Cir. 1972).

170. *Id.* at 1079 (emphasis added).

171. *See supra* Parts IIA, IIC, IVD-E.

analyze *Movielab* in terms of the criteria suggested in this article. On the one hand, the two notes over which the dispute arose totaled 10,500,000 dollars, a great sum of money, and had twenty-year maturities, a relatively long term. Furthermore, the proceeds were used for a major asset acquisition, and in the common expectations of the business world, notes used for such a purpose might well be characterized as securities since securities often in fact are given in such acquisitions. These factors would indicate that the notes were properly treated as securities. On the other hand, there was not a whole series or class of notes involved, nor was there a public offering; only two long term and one short term notes were given to a single payee, and apparently the negotiations were limited to the two parties. Also, there are not enough facts given in the opinions to determine the extent to which the payee was relying on the efforts of the maker: the risk, rights, repayment and recourse factors cannot be ascertained. Finally, it is not known how the notes were characterized by the parties themselves on the financial statements. These factors might indicate that the notes were ordinary commercial notes that should not have been treated as securities. In conclusion, the notes in *Movielab* probably fell somewhere in the gray area between notes which are clearly of an investment nature and notes which are clearly of an ordinary commercial character.

When faced with such a "gray area" case, how is the court to resolve the issue? It is submitted that if, after applying the suggested criteria, it is still unclear as to how the notes should be characterized, then the courts should, and probably will, resolve the question by looking at the degree of alleged fraud involved and the amount of protection which is needed by the plaintiff. These factors do not, strictly speaking, indicate whether the instruments are securities. But if in an equitable sense it appears that a high degree of fraud was involved, or that the plaintiff is in great need of protection, then it is not inappropriate in a "gray area" case to extend to the injured party the advantages of being able to bring his claim in a federal forum under the 1934 Act. After all, "we are against fraud aren't we?"¹⁷²

172. *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967) (Milton V. Freeman relating what Summer Pike said at the SEC meeting where Rule 10b-5 was first approved). In the *Zeller* case, see *supra* note 164, the Second Circuit held that the 1934 Act, § 28(a), 15 U.S.C. § 78bb(a) (1970), which limits a plaintiff's recovery to "actual damages," does not preclude an award of consequential damages, provided the claimant establishes "the causal nexus with a good deal of certainty." CCH FED. SEC. L. REP. ¶ 93,903 at 93, 623. However, the court also stated, "We would see nothing wrong

But the "gray area" cases aside, the split in the courts calls for authoritative resolution of the problem. The only federal appellate decision on the subject is rather nebulous. But the resolution does not rest with Congress. That body has done all it can by requiring that context govern text. It cannot be expected to anticipate all of the various factual situations which may arise. Rather the resolution rests with the federal courts. And they should not attempt to fulfill their duty by resort to a literal language approach.

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in a principle varying the required degree of certainty somewhat inversely with the depth of the fraud." *Id.* at 93,623 n.11. To be sure, the court was not discussing whether it would be more disposed to find that the instrument involved was a security in a "gray area" case where the degree of fraud was high; the court had already held that the note was a security. Nevertheless, the court's statement clearly indicated a disposition to grant more readily the protections of the federal securities laws where the degree of fraud is great. It would not be illogical to expect a similar disposition to appear where the question is whether a particular note is a security, the suggested criteria do not give a definitive answer, and the amount of fraud involved is great.