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# AN OVERVIEW OF PROMISSORY NOTES UNDER THE FEDERAL SECURITIES LAWS

## I. Introduction

The status of promissory notes<sup>1</sup> under the Securities Act of 1933<sup>2</sup> and the Securities Exchange Act of 1934<sup>3</sup> has perplexed both the judiciary and the business world for the past several years.<sup>4</sup> The problem stems from the need to discern whether the term "security" encompasses all forms of notes, or a more restricted category. This Comment will examine the Congressional intent supporting these acts and the various judicial interpretations given to their definitional sections as regards promissory notes.

Both the Securities Act of 1933<sup>5</sup> and the Securities Exchange Act of 1934<sup>6</sup> define a "security" as "any note . . . or any certificate of interest or participation in . . . any of the foregoing." This lan-

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1. Where a promissory note qualifies as a "security," federal jurisdiction is available to enforce the fraud provisions and possibly the registration requirements of the securities acts. Otherwise, an injured party is restricted to those remedies offered under state law.

2. 15 U.S.C. § 77 (1970).

3. 15 U.S.C. § 78 (1970).

4. "The definition of the term 'security,' as used in the principal federal securities laws, is for the most part one of the best kept secrets in recent legal history." Hannan and Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 *Hastings L.J.* 219 (1974). See also *McClure v. First National Bank of Lubbock, Texas*, 497 F.2d 490, 492 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975), in which the court observed that the precedent dealing with the status of notes under the securities laws is unclear due to the difficulties encountered by the judiciary in enumerating the required characteristics of a note.

5. 15 U.S.C. § 77 (1970).

6. 15 U.S.C. § 78 (1970).

7. The full text of the 1933 Act's definition of a "security" is:

When used in this subchapter, unless the context otherwise requires—

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (1970).

To promote free transferability of commercial paper, the Act exempts from its registration requirements short term notes used for current financing. § 3(a)(3), 15 U.S.C. § 77(c)(a)(3) (1970). In an advisory opinion, the Securities Exchange Commission has indicated that the scope of this exemption is quite narrow:

guage, when read literally, brings all notes under the regulation of the securities acts regardless of the circumstances under which they were issued.<sup>8</sup> Indeed, prior to 1971, this so-called literal interpretation of the statutes was adopted by nearly all courts that dealt with the issue.<sup>9</sup>

The current judicial trend is away from a literal reading of the statutes.<sup>10</sup> The effect is to exclude from federal jurisdiction certain forms of promissory notes which previously would have been included.<sup>11</sup> The Second Circuit has been extremely reluctant to stray

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The legislative history of the Act makes clear that Section 3(a)(3) applies only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks. Securities Act Release No. 4412 (Sept. 20, 1961). The anti-fraud provisions, however, include notes of all maturities. See § 17(c), 15 U.S.C. 77q(c) (1970).

The 1934 Act provides a similar definition of a "security:"

(a) When used in this chapter, unless the context otherwise requires— . . .

(10) 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 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.

15 U.S.C. § 78c(a)(10) (1970).

Although there are differences between these two definitions, the United States Supreme Court has held that they are "virtually identical" and thus they will be treated as such. *Tcherepnin v. Knight*, 389 U.S. 332, 342 (1967).

8. This is qualified by the exemption for short term commercial paper in the 1933 Act and the definitional exemption for short term notes in the 1934 Act. See note 7 *supra*.

9. This stage of judicial interpretation was aptly summarized by Judge Goldberg of the United States Court of Appeals for the Fifth Circuit: the "definition of a security has been literally read by the judiciary to the extent that almost all notes are held to be securities." *Lehigh Valley Trust Co. v. Central National Bank of Jacksonville*, 409 F.2d 989, 991-92 (5th Cir. 1969).

See, e.g., *Rekant v. Dresser*, 425 F.2d 872 (5th Cir. 1970); *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954); *Movielab, Inc. v. Berkey Photo, Inc.*, 321 F. Supp. 806 (S.D.N.Y. 1970), *aff'd*, 452 F.2d 662 (2d Cir. 1971); *Prentice v. Hsu*, 280 F. Supp. 884 (S.D.N.Y. 1968); *S.E.C. v. Vanco, Inc.*, 166 F. Supp. 422 (D.N.J. 1958), *aff'd*, 283 F.2d 304 (3d Cir. 1960).

10. See notes 39-66 and accompanying text *infra*.

11. In some cases, the reverse effect has resulted; that is, the inclusion of a note which previously would have been excluded. See *Sanders v. John Nuveen & Co.*, 463 F.2d 1075 (7th

from a literal interpretation of the acts,<sup>12</sup> despite a rejection of this approach by the United States Supreme Court<sup>13</sup> and by all the circuit courts which have recently considered this issue.<sup>14</sup> The Second Circuit thus remains the final stronghold of the traditional, literal view.<sup>15</sup>

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Cir.), *cert. denied*, 409 U.S. 1009 (1972) (promissory notes with a maturity of less than nine months were held to be securities within the Securities Exchange Act of 1934 despite the definitional exclusion of short-term instruments).

12. See, e.g., *Exchange Nat'l. Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976); *Forman v. Community Services, Inc.*, 500 F.2d 1246 (2d Cir.), *rev'd sub nom. United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975).

13. See notes 143-45 and accompanying text *infra*.

14. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 n.14 (1974).

15. It may be more accurate to describe the present position of the Second Circuit as one of confusion. This status results from a desire to follow the movement away from a literal view, coupled with a distrust of the standards thus far applied by other courts in segregating those notes which qualify for federal protection from those which are excluded. See notes 117-86 and accompanying text *infra*.

A clarification of the current position of the Second Circuit, regardless of which approach is selected, would clearly be valuable to all persons dealing in transactions involving promissory notes. Generally, a party alleging fraud in the sale or exchange of promissory notes prefers the literal view as this broadens the scope of federal jurisdiction. (*But see* note 11 *supra* for transactions involving notes with maturities not exceeding nine months). A federal cause of action is more desirable to a defrauded party because of the procedural advantages offered by the securities acts which are unavailable under most state laws. The federal statutes provide for worldwide service of process and nationwide venue. 15 U.S.C. § 77v (1970); 15 U.S.C. § 78aa (1970). This aids the plaintiff in the initial suit, and simplifies the collection of an unsatisfied judgment since a successful plaintiff need not sue to enforce the judgment in other jurisdictions. In addition, shareholder derivative actions may be maintained without the need for large security deposits which may otherwise be required under state law to guarantee reimbursement of all expenses incurred by a prevailing defendant. *E.g.*, CAL. CORP. CODE § 800 (West 1977); N.Y. BUS. CORP. LAW § 627 (McKinney 1965).

Prior to 1976, it might have been possible to succeed in a civil fraud action under the 1933 or 1934 Acts without having to prove the common law fraud requirement of scienter. See Comment, *Notes as Securities Act of 1933 and the Securities Exchange Act of 1934*, 36 Md. L. Rev. 233 n.4. This clearly made the federal forum preferable as negligence alone is far easier to prove. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), altered this by holding that some element of scienter is essential to any action based on §10(b) of the 1934 Act or the S.E.C.'s Rule 10b-5. It is too early to determine the full effect of this holding upon the desirability of a federal claim as opposed to an action under state law. For additional discussion of the advantages of federal jurisdiction, see Comment, *Notes as Securities Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 36 Md. L. Rev. 233, 233-34 nn. 4 & 5 (1976); Comment, *Any Promissory Note: The Obscene Security. A Search for the Non-Commercial Investment*, 7 Tex. Tech. L. Rev. 25, 30-31 (1975); Comment, *The Status of the Promissory Note Under the Federal Securities Laws*, 1975 Ariz. St. L.J. 175, 177-78.

## II. Legislative Intent

The proper construction of the term "security" is governed by Congressional intent.<sup>16</sup> Thus, in order to determine the scope of the securities acts as regards notes, it is necessary to examine the legislative history supporting these statutes.

The overriding purpose behind the federal securities laws was to regulate the nation's financial markets.<sup>17</sup> This regulation was thought necessary in order to prevent the further occurrence of certain abuses which contributed substantially to the plunge of the stock market in 1929 and the resulting depression.<sup>18</sup> The acts were not designed to serve as general antifraud provisions governing all forms of transactions, but rather were directed towards the protection of investors.<sup>19</sup> This objective is clearly illustrated by the Senate Reports which accompanied the 1933 Act:

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.<sup>20</sup>

In *McClure v. First National Bank of Lubbock, Texas*,<sup>21</sup> the district court observed that the passage of the Truth in Lending Act<sup>22</sup> served as an indication that Congress itself did not feel that the securities laws extended protection to consumer loans, and by implication to commercial loans as well.<sup>23</sup> Furthermore, in enumerating those transactions exempted from the Truth in Lending Act,

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16. *S.E.C. v. Joiner Corp.*, 320 U.S. 344, 354 (1943).

17. See, e.g., *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1974); Loomis, *The Securities Exchange Act of 1934 and the Investment Advisors Act of 1940*, 28 Geo. Wash. L. Rev. 214 (1959).

18. *Id.*

19. See note 20 and accompanying text *infra*.

20. S. Rep. No. 47, 73rd Cong., 1st Sess. 1 (1933). See also Comment, *Commercial Notes and Definition of 'Security' Under Securities Act of 1934: A Note is a Note is a Note?*, 52 Neb. L. Rev. 478, 487 (1973), where in which the author notes that the messages delivered to Congress by President Roosevelt prior to the legislation of both acts indicate his concern for investments, not for "ordinary commercial notes." *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1917), where the United States Supreme Court interpreted the central purpose of the acts as being the protection of investors.

21. 352 F. Supp. 454 (N.D. Tex. 1973), *aff'd*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975). See notes 44-58 and accompanying text *infra* for additional discussion of this case.

22. 15 U.S.C. § 1601 *et seq.*

23. 352 F. Supp. at 458.

Congress distinguished "credit transactions . . . for business or commercial purposes" from "transactions in securities."<sup>24</sup> This implies that the term "security" does not encompass notes issued for credit purposes. Thus, all notes do not qualify as securities. Only those notes which partake of the qualities of an investment fall within the protections offered by the securities acts.

*United Housing Foundation, Inc. v. Forman*<sup>25</sup> serves as further support for the view that only investment notes, as opposed to commercial or consumer notes, fall within the purview of the securities laws. In *Forman*, the United States Supreme Court stated: "The focus of the Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors."<sup>26</sup> The Court determined that the nature of all securities transactions is such that Congress intended the acts to be applied where the "economic realities" underlying the transaction so required, and not simply because the name appended to the instrument was among those enumerated in the definitional sections.<sup>27</sup>

The "economic realities" analysis adopted by the *Forman* Court clearly rejects the literal approach.<sup>28</sup> The focus is now upon the "economic realities" underlying the transactions involving the notes.<sup>29</sup> If the "economic realities" support a finding that the notes

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24. 15 U.S.C. § 1603.

25. 421 U.S. 837 (1974). The Court was faced with the issue of whether shares of stock, the ownership of which were required to lease an apartment in a state subsidized and supervised non-profit housing organization, constitute securities. The stock was held not to be a security, thus reversing the Second Circuit. See notes 137-47 and accompanying text *infra* for additional discussion.

26. *Id.* at 849.

27. *Id.*

28. *Id.* Notes are no longer securities simply because they are so named. The Court noted that *S.E.C. v. Joiner*, 320 U.S. 344, 351 (1943), held "[i]nstruments may be included within [the definition of a security], as [a] matter of law, if on their face they answer to the name or description." *Id.* at 850 (emphasis added by the *Forman* Court). The *Forman* Court dismissed this language by seizing upon the conditional word "may" and concluding that in *Joiner*, the Court "was not establishing an inflexible rule barring inquiry into the economic realities underlying a transaction." *Id.*

The *Forman* Court withdrew slightly from its position of total rejection of the literal view by stating that the name given to an instrument is not "wholly irrelevant" to a determination of its status under the acts, especially in cases where a party relied upon the existence of federal jurisdiction from the outset. *Id.*

29. *Id.* at 849.

qualify as investments, they are of the type contemplated by Congress when enacting the securities laws.<sup>30</sup> If not, federal jurisdiction is unavailable. The only perplexing issue involved in this seemingly simplistic approach is the lack of a set of specific factors to be evaluated when analyzing the "economic realities." The judiciary is therefore left with the task of determining which attributes define an investment note, and thus a "security" under the federal securities laws.

### III. Historical Background and Rationale Supporting the Majority View

Traditionally, the literal approach to the definition of a security was prevalent in the federal courts.<sup>31</sup> This resulted in the inclusion of nearly all notes within the scope of the securities acts. Typical of this position is *Lehigh Valley Trust Co. v. Central National Bank of Jacksonville*.<sup>32</sup> In that case, Central National Bank was sued by Lehigh Valley, which alleged that it was induced to purchase a participation interest in a note issued to the bank. This was accomplished through the use of misstatements and omissions of material facts on the part of the bank. In holding these notes<sup>34</sup> to be within the purview of the Securities Exchange Act of 1934,<sup>35</sup> the court relied exclusively on the definitions enumerated in §3(a):<sup>36</sup> "the term 'security' means any note . . . or any certificate of interest or participation in . . . any of the foregoing [note, stock, etc.]."<sup>37</sup> The circuit court explicitly stated 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."<sup>38</sup>

The Third Circuit, in *Lino v. City Investing Co.*,<sup>39</sup> was the first court of appeals to depart from the precedent of including all prom-

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30. *Id.* The "economic realities" approach requires the judiciary to scrutinize each transaction with an eye towards legislative intent. Only those notes of an investment nature were envisioned by Congress when enacting these acts, thus all others should be excluded.

31. See note 9 *supra*.

32. 409 F.2d 989 (5th Cir. 1969).

33. *Id.* at 990-91.

34. The court also examined the transactions as participation interests. *Id.* at 992.

35. 15 U.S.C. § 78 (1970).

36. 409 F.2d at 992.

37. 15 U.S.C. § 78c(a)(10) (1970). See note 7 *supra* for the complete section.

38. 409 F.2d at 991-92.

39. 487 F.2d 689 (3d Cir. 1973).

issory notes within the securities acts. In that case, plaintiff, Lino, had purchased the right to operate two franchise sales centers from a subsidiary of City Investing Co.<sup>40</sup> Payment involved both cash and promissory notes.<sup>41</sup> The circuit court seized upon the introductory phrase to the definitional sections of both securities acts in order to avoid the literal import of the language:

All of the definitional sections involved in this case are introduced by the phrase "unless the context otherwise requires." The commercial context of this case requires a holding that the transaction did not involve a "purchase" of securities. These were personal promissory notes issued by a private party. There was no public offering of the notes, and the issuer was the person claiming to be defrauded. The notes were not procured for speculation or investment, and there is no indication that FI [the subsidiary of City Investing Co.] was soliciting venture capital from Lino.<sup>42</sup>

The *Lino* court interpreted the introductory phrase as Congressional authority which permits the judiciary to evaluate the circumstances surrounding each transaction in determining whether the securities laws are applicable.<sup>43</sup> This approach was adopted in *McClure v. First National Bank of Lubbock, Texas*,<sup>44</sup> where the owner of fifty percent of a corporation sued both the president of the corporation (who owned the remaining fifty percent) and one of the bank's loan officers.<sup>45</sup> The plaintiff claimed that the defendant, president, fraudulently induced her to agree to a \$200,000 bank loan secured by corporate assets.<sup>46</sup> The fraud resulted from representations by the defendants indicating that the money was needed for legitimate corporate purposes.<sup>47</sup> The complaint further alleged that the defendant, president, used the funds borrowed by the corporation to cancel a personal, unsecured debt which he owed to the same

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40. *Id.* at 690.

41. *Id.*

42. 487 F.2d at 694-95 (emphasis added by *Lino* court).

43. The court found the following vintage United States Supreme Court statement comforting in reaching such a novel conclusion: "a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers. *Id.* at 695 (quoting from *Holy Trinity Church v. United States*, 143 U.S. 457, 458-59 (1892)).

44. 352 F. Supp. 454 (N.D. Tex. 1973), *aff'd*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975).

45. 497 F.2d at 491-92.

46. *Id.*

47. *Id.*



bank.<sup>48</sup> The funds were replaced with the president's unsecured promissory note payable to the corporation.<sup>49</sup> Foreclosure by the bank resulted in the plaintiff bringing her suit wherein she sought both monetary and exemplary damages.<sup>50</sup>

The district court held that these notes were not "securities" within the meaning of the securities acts.<sup>51</sup> This result stemmed from a determination that the circumstances surrounding the transactions were such that a literal reading of the statutes would frustrate the goals which Congress was seeking to promote by these acts.<sup>52</sup> The court labelled the notes as "little more than ordinary commercial loans,"<sup>53</sup> the misuse of which constituted "no more than internal corporate mismanagement."<sup>54</sup>

On appeal to the Fifth Circuit, the holding was affirmed.<sup>55</sup> However, a close analysis of the opinion indicates that a somewhat different construction was given to the "context" clause.<sup>56</sup> Instead of

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48. *Id.*

49. *Id.* The defendant, president, had already discharged the debt in bankruptcy proceedings. Thus, any economic relief would have had to stem from a judgment against the bank which was also a defendant due to the actions of its loan officer. *Id.* at 491.

50. 352 F. Supp. at 456.

51. *Id.* at 458. The court buttressed its holding by noting the absence of a "purchase or sale" in the dealings which precipitated this litigation. *Id.* Thus, even if the notes had qualified as "securities," jurisdiction would still have been lacking.

52. *Id.* at 457-58. The position taken by the court was that the acts were intended to protect investors, and not commercial debtors or creditors. *Id.* See notes 16-30 *supra* for a discussion of the legislative intent.

The district court found support for its decision to analyze the circumstances surrounding the transaction in the following statement by the United States Supreme Court: "*The relevant definitional sections of the 1934 Act are for the most part unhelpful. . . .* Consequently, we must ask whether respondents' alleged conduct is of the type of fraudulent behavior meant to be forbidden by the statute. . . ." *Id.* at 457 (quoting *S.E.C. v. National Securities, Inc.*, 393 U.S. 453, 466-67 (1969)) (emphasis added by *McClure* court). An additional Supreme Court statement dealing with the applicability of several rules of statutory construction to the securities acts served as further authority for avoiding the plain language of the statute in order to more accurately serve the legislature's intentions:

However well [these rules] may serve at times to aid in deciphering legislative intent, they 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.

352 F. Supp. at 457 (quoting *S.E.C. v. Joiner Leasing Corp.*, 320 U.S. 344, 350-51 (1943)).

53. 352 F. Supp. at 457-58.

54. *Id.* at 461.

55. *McClure v. First Nat'l Bank of Lubbock, Texas*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975).

56. The "context" clause refers to the introductory language in both statutes "unless the

utilizing the introductory phrase to avoid a literal interpretation, the court focused on the definition of the term "note" and concluded that the particular notes involved lacked the attributes of an investment, and thus fell outside of the scope of the securities acts.<sup>57</sup>

On one hand, the [Securities Exchange] Act covers all *investment* notes, no matter how short their maturity, because they are not encompassed by the "any note" language of the exemption. On the other hand, the Act does not cover any *commercial* notes, no matter how long their maturity, because they fall outside the "any note" definition of a security. Thus, the investment or commercial nature of a note entirely controls the applicability of the Act, depriving of all utility the exemption based on maturity-length.<sup>58</sup>

The analysis applied by the court of appeals in *McClure*<sup>59</sup> is more accurate than that of the district court<sup>60</sup> or the *Lino* court.<sup>61</sup> The "context" referred to in the prefacing phrase is that of the statute itself, not the circumstances surrounding the transaction.<sup>62</sup> Congress was simply issuing a warning indicating that the definition of a term may vary depending upon which section of the statute is being applied.<sup>63</sup> Once the definition of a term is properly resolved according to the statutory context, it is "applied to, not defined by" the transaction in issue.<sup>64</sup>

The legislative intent indicates that the term "note," within the

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context otherwise requires." See note 7 *supra*.

57. 497 F.2d at 494-95. Under this analysis, there is no need to utilize the introductory phrase "unless the context otherwise requires." See text accompanying notes 68-74 *infra* for a discussion of the test applied by the court in determining that the note under consideration did not constitute a "security."

58. *Id.* at 494-95. The court indicated that further Congressional legislation or a definitive decision by the United States Supreme Court contrary to present cases would be necessary to sustain any other view of the intent of the legislators as regards the scope of the securities acts. *Id.* at 495.

59. 497 F.2d 490 (5th Cir. 1974).

60. 352 F. Supp. 454 (N.D. Tex. 1973).

61. 487 F.2d 689 (3d Cir. 1973).

62. See Comment, *Notes as Securities Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 36 Md. L. Rev. 233, 238-39 (1976); Comment, *Any Promissory Note: The Obscene Security. A Search for the Non-Commercial Investment*, 7 Tex. Tech. L. Rev. 25, 38-89 (1975).

63. This is precisely the interpretation taken by the Supreme Court: "The meaning of particular phrases must be determined in context . . . Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the 1933 and 1934 Acts preface their lists of general definitions with the phrase 'unless the context otherwise requires.'" *S.E.C. v. National Securities, Inc.*, 393 U.S. 453, 466 (1969).

64. See *Any Promissory Note: The Obscene Security. A Search for the Non-Commercial Investment*, 7 Tex. Tech. L. Rev. 25, 40 (1975).

definitional sections of the securities acts, refers to investment notes.<sup>65</sup> Therefore, the remaining obstacle lies in applying this definition consistently so as to separate security transactions from non-security transactions.<sup>66</sup>

#### IV. Commercial Notes Versus Investment Notes

The judiciary has had much difficulty enumerating the necessary attributes of an investment note.<sup>67</sup> The result of this difficulty is the emergence of several tests, none of which is universally accepted. In *McClure v. First National Bank of Lubbock, Texas*,<sup>68</sup> the Fifth Circuit deemed the following factors particularly relevant.<sup>69</sup> Where the notes were offered to a class of investors, as opposed to a private transaction between two parties, or were acquired for speculative or investment purposes, the court would apply the securities acts.<sup>70</sup> The second factor involved an examination of the *quid pro quo*:<sup>71</sup> where the maker received investment assets in exchange for the notes, *McClure* would hold that an investment note was present, and thus that the securities laws were applicable.<sup>72</sup> This approach, although sufficient for rejecting the claim presented in *McClure*,<sup>73</sup> is clearly inadequate for general application. The court made no attempt to define the terms "investment" or "investment assets." Yet, these are indicia whose presence, according to *McClure*, trigger the application of the securities acts.<sup>74</sup> An analysis of this nature begs the question presented.

In *Zabriskie v. Lewis*,<sup>75</sup> the Tenth Circuit utilized a slightly differ-

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65. See notes 16-30 and accompanying text *supra*.

66. The interpretation of the "context" clause as referring to the context of the statute, as opposed to the context of the transaction is more accurate; however, the final analysis is likely to be the same under either view. Both approaches rely upon legislative intent, thus the dispositive issue remains the choice of criteria to be evaluated in distinguishing an investment note from a commercial note.

67. *McClure v. First Nat'l Bank of Lubbock, Texas*, 497 F.2d at 492.

68. 497 F.2d 490 (5th Cir. 1974); *cert. denied*, 420 U.S. 930 (1975).

69. *Id.* at 493. The court, however, indicated that the two factors selected are not necessarily the only indicia appropriate for consideration. *Id.* at 493 n.2.

70. *Id.*

71. *Id.* at 494.

72. *Id.* It was noted that the receipt of investment assets could occur through direct as well as indirect means. *Id.*

73. See text accompanying notes 44-50 *supra*.

74. 497 F.2d at 493-94.

75. 507 F.2d 546 (10th Cir. 1974).

ent approach in segregating investment notes from commercial notes.<sup>76</sup> The court examined the use to which the proceeds of the note were applied.<sup>77</sup> The test is similar to the second part of the *McClure* analysis where the receipt of investment assets was considered relevant.<sup>78</sup> Under *Zabriskie*, if the proceeds were used to acquire consumer goods or services, the note was commercial and outside of the acts.<sup>79</sup> Where the proceeds were used for business purposes, the transaction would invoke the securities laws if the circumstances were such that stock would usually be issued instead of promissory notes.<sup>80</sup>

This analysis is helpful in cases where it is obvious that stock would ordinarily be issued. An example is the promotion of a new corporation, as was the situation facing the *Zabriskie* court.<sup>81</sup> In addition, this approach prevents a party from circumventing the regulatory scheme provided by the securities acts simply because a note was issued instead of stock, or some other form of security.<sup>82</sup> However, the test suffers the same pitfalls as the *McClure* approach.<sup>83</sup> It was useful for those particular facts, but it is of little value in situations where the facts differ. Cases will remain unresolved under this analysis where it is unclear whether the proceeds went to business purposes or to consumer goods, or where it is difficult to determine whether stock would normally be issued. Thus, there still exists the problem of defining "investment" in order to avoid arbitrary decisions and enable potential litigators to weigh the

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76. *Id.* at 551.

77. *Id.*

78. 497 F.2d at 494.

79. 507 F.2d at 551.

80. *Id.* This part of the court's test originated in a student Comment, *Commercial Notes and Definition of 'Security' Under Securities Exchange Act of 1934: A Note is a Note is a Note?*, 52 Neb. L. Rev. 478, 501 (1973). The author also suggested several additional factors which the court felt might be applicable to other circumstances. These factors include: (1) use of proceeds to buy specific assets or services (commercial) rather than general financing (investment), (2) risk to initial investment, (3) giving certain rights to a payee (investment), (4) repaying contingent on profit or out of production (investment), (5) a large number of notes or payees (investment), (6) a large dollar amount (investment), (7) fixed time notes (equivocal) rather than demand notes (commercial), and (8) characterization by the parties themselves.

81. 507 F.2d at 551.

82. See *Rekant v. Dresser*, 425 F.2d 872, 878 (5th Cir. 1970).

83. The *Zabriskie* court failed to define the terms used within the test. Differentiating consumer usage of the proceeds from business usage does not appear any less complicated than separating commercial notes from investment notes.

merits of their respective cases.

*United Housing Foundation, Inc. v. Forman*<sup>84</sup> applied a test traditionally used in situations where it is necessary to determine whether an "investment contract" exists.<sup>85</sup> The test is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."<sup>86</sup> The Court noted that "[t]his test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."<sup>87</sup> This language would seem to require the presence of all the above-mentioned elements in order for any instrument to be properly labelled a "security."<sup>88</sup> It is extremely unlikely that the Court intended to restrict the applicability of the securities acts solely to those transactions which conform to the definition of an "investment contract." The *Forman* Court was not faced with the issue of promissory notes, and an extension of the "investment contract" analysis appears "to be of dubious value in that context."<sup>89</sup> Thus, the decision sheds no light on the proper focus of the judiciary in distinguishing an investment note from a commercial note.

A final approach which merits analysis is the so-called "risk capital" test applied recently by the Ninth Circuit in *Great Western Bank & Trust v. Kotz*.<sup>90</sup> This view maintains the commer-

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84. 421 U.S. 837 (1974).

85. The test was originally espoused in *S.E.C. v. Howey Co.*, 328 U.S. 293 (1945). The Court was presented with the question of whether an "investment contract" existed where the defendants had publicly offered certain land-sale contracts for the purchase of small citrus groves. The offers were coupled with optional service contracts engaging the defendants to harvest and market the produce and distribute the pooled revenue among the purchasers. The Court determined that an "investment contract" was present, thus triggering the application of the securities laws since the definitional sections of both acts expressly include "investment contracts." See note 7 *supra*.

86. *Id.* at 301.

87. 421 U.S. at 852.

88. Several commentators have taken precisely this position. See Comment, *Notes as Securities Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 36 Md. L. Rev. 233 (1976); Comment, *Any Promissory Note: The Obscene Security. A Search for the Non-Commercial Investment*, 7 Tex. Tech. L. Rev. 25 (1975); Comment, *The Status of the Promissory Note Under the Federal Securities Laws*, 1975 Ariz. St. L. J. 175.

89. *Exchange Nat'l Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1136 (2d Cir. 1976).

90. 532 F.2d 1252 (9th Cir. 1976). The court was faced with the question of whether

cial/investment dichotomy, but analyzes "the nature and degree of risk accompanying the transaction to the party providing the funds" in determining whether an investment (and thus a security) is present.<sup>91</sup> In addition, this approach requires that the "risk capital" be subject to "the entrepreneurial or managerial efforts" of others before it will rise to the status of a "security."<sup>92</sup>

The court provided several criteria to be used in distinguishing a "risky loan," which falls outside of the scope of the acts, from "risk capital," which qualifies as a security.<sup>93</sup> The most significant factor is the maturity length of the notes:<sup>94</sup> the longer the notes entitle the issuer to the funds, the greater the risk of loss.<sup>95</sup> The court extended this to the point of stating that a note of short-term maturity is "almost *ipso facto* not a security unless payment is dependent upon the success of a risky enterprise, or the parties contemplate indefinite extension of the note or perhaps conversion to stock."<sup>96</sup> The logic behind this approach appears to be circular. The court was attempting to distinguish notes which qualify as "securities" from those which are merely commercial loans.<sup>97</sup> The test applied relies predominantly on an assessment of the risk involved in the transaction as measured by maturity-length, but an exception is provided for situations where repayment hinges upon the future of a "risky enterprise."<sup>98</sup> It is apparent that this approach will only create confusing results.<sup>99</sup>

A second factor considered under the "risk capital" analysis is the extent of collateralization, if any.<sup>100</sup> The reasoning is that an unsecured creditor is more dependent upon the efforts of the obligor than

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corporate notes issued in return for a ten-month line of credit from Great Western Bank & Trust were "securities" under the 1933 and 1934 Acts. *Id.* at 1253. In a *per curiam* opinion, the notes were held not to be securities, thus affirming the district court's dismissal. *Id.*

91. *Id.* at 1256.

92. *Id.* at 1257.

93. *Id.* at 1257-58.

94. *Id.* at 1257.

95. The court acknowledged the existence of prior decisions indicating that maturity length is nondispositive of the commercial/investment dilemma, but still concluded that it was a significant element. *Id.*

96. *Id.* at 1257-58.

97. *Id.* at 1256.

98. *Id.* at 1257-58.

99. The court indicated that other provisions in the note, such as callability by the obligee, may totally invalidate the time-based test. *Id.* at 1258.

100. *Id.*

a secured creditor, and thus the risk of loss is greater.<sup>101</sup> This factor is also subject to exceptions, as noted by the court itself, and thus fails to serve as a reliable indicator of a "security."<sup>102</sup>

Other indicia weighed by the court include the form of the obligation,<sup>103</sup> the circumstances surrounding its issuance,<sup>104</sup> the relationship between the amount involved and the size of the obligor's business,<sup>105</sup> and the contemplated use of the proceeds.<sup>106</sup> None of the above factors considered by the court was controlling,<sup>107</sup> and the court expressly stated that future cases may require new sets of considerations to be evaluated.<sup>108</sup> In addition, no attempt was made to indicate the magnitude of risk necessary to elevate a commercial note to the level of an investment.<sup>109</sup>

There are other faults which contribute to the weakness of the "risk capital" approach. Because the test relies exclusively on the level of risk involved, uncollateralized personal loans made by a bank could be classified as securities due to the high level of risk, although they are no more than ordinary commercial loans.<sup>110</sup> As the financial status of the maker weakens, the risk factor increases. It is not likely that the legislature intended the application of the

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101. *Id.*

102. The court noted that situations do exist where a secured obligee is as dependant upon the efforts of others as is an unsecured obligee; for example, where the "investment" is collateralized by common stock of the obligor. *Id.* at 1258 n.4.

103. *Id.* at 1258. The form of the obligation is of little, if any, significance. The Supreme Court has indicated on many occasions that substance governs over form in cases where the two differ. See, e.g., *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1974) (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).

104. 532 F.2d at 1258. This factor is equivalent to the first prong of the *McClure* test, namely, whether the obligations were issued to a single party or a class of investors. 497 F.2d at 493.

105. 532 F.2d at 1258. The court reasoned that as the size of the "loan" increases in relation to the total size of the borrower's business, the risk to the lender also increases. *Id.*

106. *Id.* Those proceeds essential to the formation of a new enterprise are more likely to be securities than proceeds needed to maintain current working capital because the latter type generate a return more rapidly and thus are less risky. *Id.*

107. *Id.*

108. *Id.*

109. One commentator has observed that despite a sizable list of criteria to be evaluated, the court still is required to draw an arbitrary distinction because the test fails to provide workable guidelines for measuring the required level of risk. Pollock, *Notes Issued in Syndicated Loans—A New Test to Define Securities*, 32 Bus. Law. 537, 544 (1977).

110. In a concurring opinion, Judge Eugene Wright suggests that all notes received by a bank as a result of funds extended through its normal lending channels are no more than commercial loans. 532 F.2d at 1262 (Wright, J., concurring). See note 162 *infra* for additional discussion.

securities laws to hinge on the financial strength of either party.<sup>111</sup>

The "risk capital" approach does not provide a definitive standard which will distinguish investments from commercial loans. Every lender of money incurs certain risks in anticipation of earning a profit.<sup>112</sup> Therefore, judicial decisions under this analysis can only lead to arbitrary holdings.<sup>113</sup>

The cases indicate that the courts have attempted to create a distinction, grounded in Congressional intent, in order to prevent all notes from being included under the securities laws.<sup>114</sup> The distinction divides notes into two classes: investment notes and commercial notes.<sup>115</sup> This test poses no obstacles to those cases falling squarely within either extreme. It would not be disputed that a note issued in exchange for a part-ownership in an enterprise qualifies as an investment, nor that a note issued to a bank in exchange for a loan needed to finance homeowner improvements constitutes a commercial note. But there remains a sizable "grey area" within which a decision under the present case law can only be arbitrary since all efforts to promulgate a definitive set of factors which lead to predictable results have been fruitless.<sup>116</sup> It is perhaps this unfortunate situation which has prompted the Second Circuit to remain the sole federal forum which continues to rely upon the literal approach.

## V. The Second Circuit

The Second Circuit's first encounter with the issue of notes vis-a-vis the securities laws was in *Movielab, Inc. v. Berkey Photo, Inc.*<sup>117</sup> *Movielab*, a publicly owned corporation, had purchased certain assets from *Berkey Photo*, also a public corporation, in exchange for two twenty-year notes in the amount of \$5,250,000 each.<sup>118</sup> Subsequently, *Movielab* alleged fraud in the transaction

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111. 32 Bus. Law. at 544.

112. *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354, 1359 (7th Cir.), cert. denied, 423 U.S. 825 (1975).

113. By coupling the fact that certain risks are inherent in all commercial and investment notes with the lack of an adequate mechanism for evaluating the magnitude of risk, it becomes apparent that the "risk capital" approach is of little value to future courts dealing with promissory notes.

114. See notes 16-30 and accompanying text *supra* dealing with legislative intent.

115. *Id.*

116. See notes 67-113 and accompanying text *supra*.

117. 321 F. Supp. 806 (S.D.N.Y. 1970), *aff'd*, 452 F.2d 662 (2d Cir. 1971).

118. 452 F.2d at 663.



and sought rescission and damages.<sup>119</sup>

The district court noted the Congressional intent supporting the statute<sup>120</sup> and the difficulties which might arise if federal jurisdiction could be invoked in connection with fraud involving all types of notes,<sup>121</sup> but the court was unwilling to depart from the literal import of the language in the acts.<sup>122</sup> The court felt that the clarity of the language prevented the application of any judicial discretion in interpreting the definition of "security" and concluded that the acts constituted a "sweeping prohibition" against fraud.<sup>123</sup>

On appeal, the Second Circuit affirmed in a *per curiam* opinion.<sup>124</sup> However, the court expressly stated that it was not deciding the issue of whether federal jurisdiction would always be available in connection with the issuance of all notes, regardless of how small the transaction.<sup>125</sup> Thus, the court left itself room to adopt a more flexible approach, if desirable, without being hindered by precedent which unequivocally required a literal interpretation.

The next case involving promissory notes under the securities acts was *Zeller v. Boque Electric Manufacturing Corp.*<sup>126</sup> Boque Electric had issued a demand note to its subsidiary, Belco Pollution Control Corporation, to replace several open account loans totalling \$315,310.<sup>127</sup> Zeller, a shareholder in Belco, brought this derivative action alleging that the terms of the note constituted violations of

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119. *Id.*

120. "The primary purpose behind the adoption of the antifraud provisions of the 1933 and 1934 Acts was to protect public investors . . . ." 321 F. Supp. at 808.

121. *Id.* The court was concerned with the "floodgate" type situation which might arise if disputes involving all notes could be litigated in federal courts. *See also* Bellah v. First Nat'l Bank of Hereford, 495 F.2d 1109 (5th Cir. 1974).

122. 321 F. Supp. at 808. The court quoted from *Addison v. Holly Hill Fruit Prods., Inc.*, 322 U.S. 607, 617-18, wherein the Supreme Court stated:

For the ultimate question is what has Congress commanded, when it has given no clue to its intentions except familiar English words and no hint by the draftsmen of the words that they meant to use them in any but an ordinary sense . . . . After all, legislation . . . is addressed to the common run of men and is therefore to be understood according to the sense of the thing, as the ordinary man has a right to rely on ordinary words addressed to him.

321 F. Supp. at 808.

123. 321 F. Supp. at 809.

124. 452 F.2d at 664.

125. *Id.* at 663.

126. 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973).

127. *Id.* at 797.

both securities acts.<sup>128</sup>

The court first analyzed the definitional distinctions between the two securities acts and concluded that the nine-month exemption provided in section 3(a)(3) of the Securities Act of 1933<sup>129</sup> and in section 3(a)(10) of the Securities Exchange Act of 1934<sup>130</sup> was applicable only to prime quality negotiable commercial paper, as suggested by the Securities Exchange Commission.<sup>131</sup> This view is in accord with other circuits: a note's maturity length is not dispositive of its status under the securities acts.<sup>132</sup>

The *Zeller* court then made the following statement which seemingly indicated its rejection of the literal approach applied in *Movielab*, and its adoption of the commercial/investment analysis:

It does not follow . . . that every transaction within the introductory clause of § 10, which involves promissory notes, whether of less or more than nine months maturity, is within [the coverage of the securities acts] . . . . The Act is for the protection of investors, and its provisions must be read accordingly . . . . But we see no reason to doubt that Belco stood in the position of an investor . . . .<sup>133</sup>

*Zeller* thus determined that an investment note was present and accordingly granted federal jurisdiction.<sup>134</sup>

The *Zeller* court cited *Movielab* as support for applying the commercial/investment analysis.<sup>135</sup> However, *Movielab* had only hinted at the possibility of relaxing the strict statutory construction previously applied by the Second Circuit.<sup>136</sup> *Zeller* extended this dictum, and thus shifted the focus of attention from the language of statutes, to the legislative intent supporting the statutes.

*Forman v. Community Service, Inc.*<sup>137</sup> presented the Second Circuit with the question of whether shares of stock in a nonprofit

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128. *Id.* In addition, the plaintiff sought pendent jurisdiction for violations of the securities laws of New York and New Jersey. *Id.* at 799.

129. *See* note 7 *supra*.

130. *Id.*

131. *Id.*

132. *See* notes 39-65 and accompanying text *supra*.

133. 476 F.2d at 800.

134. *Id.* The court, therefore, reached the same result that would have been attained had a literal interpretation been applied.

135. 476 F.2d at 800.

136. *See* text accompanying note 125 *supra*.

137. 500 F.2d 1246 (2d Cir.), *rev'd sub nom.* United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1974).

cooperative housing company constitute "securities" under federal law.<sup>138</sup> The court definitively applied a strict literalist approach.<sup>139</sup> The stock was held to be a security regardless of the nature of the transaction because "on its face" it was a share of stock and therefore within the statutory definition.<sup>140</sup>

The *Forman* case, although dealing with the issue of "stock" rather than "notes," constituted a clear retreat from the more flexible position taken in *Zeller*.<sup>141</sup> On appeal,<sup>142</sup> the Supreme Court reversed and expressly rejected the literal approach.<sup>143</sup> The Court cited *Tcherepnin v. Knight*<sup>144</sup> which stated that when "searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality."<sup>145</sup>

*Forman*, if read narrowly, can be construed as having abandoned the literal view in favor of a "substance over form" analysis only where the transaction involved stock. However, the obvious extension of this approach is its application to notes, as well as all instruments enumerated within the definitional sections. The securities

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138. 500 F.2d at 1248. The action was brought by 57 residents who alleged fraud in the sale of this stock resulting from "misrepresentations and material omissions" in certain literature which was intended to attract purchasers. *Id.* at 1248-50. All residents of the cooperative were required to purchase 18 shares of stock at \$25 par value for each room in their apartment. *Id.* Owners of stock were accorded only one vote on all matters, regardless of the number of shares they owned; and, all stock was subject to the corporation's first rights of refusal should a party move from the apartment building. If this right was refused, the stock could have been sold to other dwellers at the original price plus a pro-rata share of the mortgage amortization paid while the seller occupied his apartment. *Id.*

139. *Id.* at 1252. The court was aware of the growing attraction of the substance over form approach, but felt that it was applicable only where federal jurisdiction was being expanded. *Id.* at 1253. Where it was being contracted, the court felt that substance reigned supreme. *Id.*

The court bolstered its holding by additionally finding that the stock constituted an "investment contract" under the test set down in *Howey*. *Id.* at 1253-55.

140. *Id.* at 1252.

141. 476 F.2d 795 (2d Cir. 1973).

142. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1974).

143. *Id.* at 847.

144. 389 U.S. 332 (1967).

145. 421 U.S. at 848 (quoting *Tcherepnin*, 389 U.S. at 336). The *Forman* Court rejected certain language in several prior decisions which might have been viewed as supporting a literal view. 421 U.S. at 850. However, the Court did indicate that if a purchaser justifiably relied on the availability of federal jurisdiction when acquiring the notes, the literal view might then be appropriate.

The Court also rejected the circuit court's determination that an investment contract existed, thus definitively depriving the parties of federal protection. *Id.* at 851-58.

laws apply uniformly to all instruments which qualify,<sup>146</sup> and Congressional intent is better served by the "substance over form" interpretation.<sup>147</sup> Thus, it is reasonable to interpret *Forman* as a mandate requiring an overall rejection of the literal interpretation in favor of a more flexible view, such as that taken in *Zeller*.

The first Second Circuit case to interpret *Forman* in a transaction which involved promissory notes was *Exchange National Bank of Chicago v. Touche Ross & Co.*<sup>148</sup> In that case, Touche Ross & Co. was sued by the Exchange National Bank for violations of the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.<sup>149</sup> The bank had purchased from a brokerage firm three unsecured subordinated notes in the aggregate principal of \$1 million.<sup>150</sup> The complaint alleged that the Bank had relied upon opinions of Touche Ross & Co. which indicated that the financial statements of the brokerage firm fairly presented its financial position and conformed to generally accepted accounting principles.<sup>151</sup> In fact, the financial position of the brokerage firm was far weaker than indicated in the accounting reports, and the firm had been placed in receivership with its assets being liquidated prior to the suit.<sup>152</sup>

Judge Friendly, writing for the court, determined that the notes in question constituted "securities."<sup>153</sup> The defendant's motion to dismiss for lack of subject matter jurisdiction was therefore dismissed.<sup>154</sup> The court reviewed the judicial trend towards the application of the commercial/investment test for classifying notes,<sup>155</sup> and

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146. The definitional sections determine which instruments qualify for the application of the remainder of the acts.

147. See notes 16-30 and accompanying text *supra*.

148. 544 F.2d 1126 (2d Cir. 1976).

149. *Id.* at 1127. The complaint specifically alleged violations of §17a of the Securities Act of 1933, §§ 10b, 15c, 17a, and 18a of the Securities Exchange Act of 1934, the S.E.C.'s Rule 10b-5, and a pendent state law claim for negligence. *Id.*

150. *Id.* at 1128. The provisions contained within the notes were keyed to certain rules of the New York Stock Exchange so that the proceeds could be utilized by the brokerage firm to satisfy minimum capital requirements necessary to be listed on the exchange. *Id.* at 1129.

151. *Id.* at 1128.

152. *Id.* The bank felt that Touche Ross knew or should have known that the statements it based its opinions upon contained false and misleading entries. *Id.*

153. 544 F.2d at 1138.

154. *Id.* at 1130.

155. *Id.* at 1133-36. The court discussed the following cases: *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976) (see notes 90-113 and accompanying text *supra*); *C.N.S. Enterprises, Inc. v. G & G Enterprises, Inc.*, 508 F.2d 1354 (7th Cir. 1975), *cert. denied*, 423

the strong antiliteralist language of the Court in *Forman*,<sup>156</sup> but concluded that the language of the securities acts was sufficiently precise to warrant strict adherence:

So long as the statutes remain as they have been for over forty years, courts had better not depart from their words without strong support for the conviction that, under the authority vested in them by the "context" clause, they are doing what Congress wanted when they refuse to do what it said.<sup>157</sup>

The court's decision to apply a literal standard does not appear to stem from a rejection of the rationale underlying the commercial/investment dichotomy. Instead, it seems to result from a realization that there presently does not exist a test which can be used by the judiciary to arrive at predictable results.<sup>158</sup> In searching for a viable solution to the literal view, the court was attracted to the test proposed by Judge Wright's concurring opinion in *Great Western Bank & Trust v. Kotz*.<sup>159</sup> There it was suggested that all notes received by a bank through its normal lending channels constitute commercial loans and thus are not "securities."<sup>160</sup> This view, accord-

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U.S. 825 (1975) (notes given as earnest money deposits were ordinary commercial paper and thus not entitled to federal protection); *McClure v. First National Bank of Lubbock, Texas*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975) (*see* notes 44-58, 68-74 and accompanying text *supra*); *Bellah v. First Nat'l Bank of Hereford*, 495 F.2d 1109 (5th Cir. 1974) (The court applied the commercial/investment dichotomy holding a 6-month note not be a "security" under the Securities Exchange Act of 1934); *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974) (*see* notes 75-83 and accompanying text *supra*); *S.E.C. v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974) (The court held certain promissory notes, including several with maturity-lengths of less than nine-months, issued to reimburse customers of a brokerage firm to be securities); *Lino v. City Investing Co.*, 487 F.2d 689 (3d Cir. 1973) (*see* notes 39-43 and accompanying text *supra*); *Zeller v. Boque Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir. 1973), *cert. denied*, 414 U.S. 908 (1973) (*see* notes 126-36 and accompanying text *supra*); *Movielab, Inc. v. Berkey Photo, Inc.*, 452 F.2d 662 (2d Cir. 1971) (*see* notes 117-25 and accompanying text *supra*).

156. 421 U.S. 837, 848 (1974) where the Supreme Court stated: "We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called 'stock,' must be considered a security transaction simply because the statutory definition of a security includes the words 'any . . . stock.'" The Court also stated that "a thing may be within the letter of the statute, and yet not within the statute, because not within its spirit, nor within the intention of its makers." *Id.* at 849 (quoting *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459 (1892)).

157. 544 F.2d at 1138.

158. The court summarized all of the decisions cited in note 155 *supra* and concluded that "the efforts to provide meaningful criteria for decision under 'the commercial-investment' dichotomy do not seem to us to carry much promise of success." *Id.* at 1136.

159. 532 F.2d 1252 (9th Cir. 1976).

160. *Id.* at 1260-62.

ing to *Exchange National Bank*, "would afford the hope of bringing a modicum of certainty into one large section of a field in bad need of it."<sup>161</sup> However, despite this optimistic language, Judge Wright's approach was rejected because it would be inequitable to preclude federal jurisdiction in all controversies involving a bank, especially where the borrower asserts fraud on the part of the lender.<sup>162</sup>

The literal interpretation of the acts in *Exchange National Bank* is not without qualification. The court indicated that the introductory phrase "unless the context otherwise requires" might be applicable in future cases so as to avoid the literal impact of the statutory language.<sup>163</sup> However, the party seeking that result has the burden of proving that the context is such as to require exceptional treatment.<sup>164</sup> The court enumerated several transactions sufficient to meet the required burden of proof:

[T]he note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized).<sup>165</sup>

Unless a note is issued under circumstances strongly resembling one of the examples listed above, the Second Circuit generally will adhere to the statutory language.<sup>166</sup>

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161. 544 F.2d at 1137.

162. *Id.* at 1138. Judge Wright based his opinion on the premise that a bank typically has a "superior bargaining position and can compel wide-ranging disclosures and verification of issues material to its decision on the loan application." 532 F.2d at 1262. The *Exchange National Bank* Court approved of this reasoning where the suit was brought by a bank, but felt it inappropriate in actions brought against a bank since the bank's powerful methods of disclosure are of no advantage to the issuer of the note. 544 F.2d at 1136-37. As a result, Judge Wright's approach had to be rejected because the statute would not permit the same note to be a security where the action was initiated by the borrower, but a commercial note where the action was initiated by the bank. *Id.* at 1137.

163. *Id.* at 1137-38.

164. *Id.*

165. *Id.* at 1138.

166. *Id.* The court acknowledged that this analysis is deficient in not affording complete certainty, but considered it superior to the approaches taken by the other circuits. *Id.* It is noted that "[a] more desirable solution would be for Congress to change the exclusions to encompass 'a note or other evidence of indebtedness issued in a mercantile transaction,' as is proposed in the ALI's Federal Securities Code, § 297(b)(3) . . . ." *Id.* This could be complemented with a delegation of authority to the S.E.C. to explicate the quoted phrase. *Id.*

*Exchange National Bank*, therefore, returns the Second Circuit to the traditional, literal view despite the Supreme Court's contradictory language in *Forman*.<sup>167</sup> This position is qualified by the potential future application of the introductory phrase "unless the context otherwise requires."<sup>168</sup> The literal view was selected because the *Exchange National Bank* court felt that the approaches used elsewhere failed to provide predictable results.<sup>169</sup> However, the addition of the "context" clause qualification injects an element of unpredictability into the literal view, and thus defeats the goal of avoiding arbitrary results. With the inclusion of this qualification, the present position of the Second Circuit is best described as falling somewhere between a strict literal view and the majority's commercial/investment analysis.<sup>170</sup>

*Altman v. Knight*<sup>171</sup> was the first district court case within the Second Circuit to interpret *Exchange National Bank v. Touche Ross & Co.*<sup>172</sup> In *Altman*, the plaintiff alleged violations of the Securities Exchange Act by the directors of Anaconda in the purchase of another company.<sup>173</sup> Subject matter jurisdiction was based on the existence of a "security" in the form of a five-year note.<sup>174</sup> The *Altman* court noted the application of the literal interpretation by *Exchange National Bank*,<sup>175</sup> but nonetheless declined to include the note issued by Anaconda within the definition of a "security."<sup>176</sup> Instead, *Altman* determined that the note was "similar in many respects to a 'note delivered in consumer financing.'"<sup>177</sup> Thus, the defendants had met the burden of proof required by *Exchange National Bank* in order to avoid the literal import of the statutory

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167. See notes 131-47, 156 and accompanying text *supra*.

168. See notes 163-65 and accompanying text *supra*.

169. See notes 158-62 and accompanying text *supra*.

170. The court was apparently unsure of the wisdom of relying exclusively upon an application of the literal approach in light of its having been rejected in all other circuits. Thus, in the concluding paragraphs of the opinion, the commercial/investment approach was applied as additional support for the determination that the notes did qualify as "securities." 544 F.2d at 1138-39.

171. 431 F. Supp. 309 (S.D.N.Y. 1977).

172. 544 F.2d 1126 (1976).

173. 431 F. Supp. at 311.

174. *Id.*

175. *Id.* at 311-12.

176. *Id.* at 312.

177. *Id.*

language.<sup>178</sup> Hence, the very first case within the Second Circuit to apply the *Exchange National Bank* reasoning reached a result *contra* to the literal interpretation by applying the "context" clause qualification.

The *Altman* court, despite having satisfied the requirements of *Exchange National Bank*, sought additional support for its holding. The court cited *Emisco Industries, Inc. v. Pro's Inc.*,<sup>179</sup> a recent Seventh Circuit case with a similar factual pattern. There, the commercial/investment dichotomy was utilized to reach the conclusion that the notes involved were not "securities," but rather a cash substitute in the nature of a loan.<sup>180</sup> The notes in *Altman* were also described as being a substitute for cash.<sup>181</sup> Thus, *Altman* is consistent with the commercial/investment approach as well as with *Exchange National Bank*. But because the court felt obligated to bolster its conclusion through the citation of a case which applied the commercial/investment test, *Altman* indicates either that *Exchange National Bank* failed to clarify fully the proper application of its analysis,<sup>182</sup> or that *Altman* felt that *Exchange National Bank* did not properly interpret the antiliteralist language of the United States Supreme Court in *United Housing Foundation, Inc. v. Forman*.<sup>183</sup> Regardless of the cause, *Altman* deemed it appropriate to apply both analyses, an approach, which if followed by future courts, can only lead to total confusion.<sup>184</sup>

*Altman* plainly demonstrated that the Second Circuit should reevaluate, or at least clarify, its present stature. The purpose in adhering to the literal interpretation in *Exchange National Bank* was to promote predictability for the benefit of both the judiciary

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178. See notes 163-65 and accompanying text *supra*.

179. 543 F.2d 38 (7th Cir. 1976).

180. *Id.* at 40.

181. 431 F. Supp. at 312.

182. It is quite plausible that the district court was not certain that it had properly applied the test described in *Exchange National Bank*, especially since the court was utilizing the "context" clause exception to the general rule of literal interpretation.

183. See note 156 *supra*.

184. In the concluding paragraphs of *Exchange National Bank*, the Second Circuit also fortified its holding by applying the commercial/investment dichotomy. 544 F.2d at 1138. The use of the literal approach itself is of questionable validity in light of the generally accepted interpretations of Congressional intent and the strong antiliteralist language in *Foreman* (see notes 16-30, 156 and accompanying text *supra*), but the application of both the literal and the commercial/investment analyses is purposeless.



and potential litigators.<sup>185</sup> However, the qualification incorporated by *Exchange National Bank* prevents the attainment of that goal.<sup>186</sup> In addition, the literal approach denies to the Second Circuit the use of precedent set down in other forums. This creates a situation which is likely to lead to an even greater number of arbitrary results than would the application of the commercial/investment test.

## VI. Conclusion

The Second Circuit's application of a literal approach in delineating the parameters of the Securities Act of 1933 and the Securities Exchange Act of 1934 with respect to promissory notes should be rejected in favor of the commercial/investment analysis. The literal interpretation fails to accommodate Congressional intent,<sup>187</sup> and offers little, if any, advantage in attaining more predictable results.<sup>188</sup> By contrast, the commercial/investment analysis was specifically created as a means of more accurately achieving the goals envisioned by Congress when enacting the securities laws.<sup>189</sup> It is additionally favorable in that it permits the utilization of the body of precedent that has developed and will continue to develop in the remainder of the federal courts.

The optimal solution is for Congress to enact clarifying legislation which definitively states its position on the scope of the securities acts. Further Supreme Court rulings would certainly be of value; however, the current dilemma exists because the legislative intent is not accurately expressed within the statutes. Thus, Congressional action is decidedly preferable. Until either Congress or the Supreme Court alters the present status of the law, the judiciary should continue to evaluate each case individually and utilize prior case law to aid in the task of segregating notes issued in commercial transactions, which do not qualify as securities, from notes issued in investment transactions, which entitle the parties to seek redress in the federal courts.

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185. See note 158 and accompanying text *supra*.

186. *Altman* exemplifies the fact that the literal approach taken by the Second Circuit does not necessarily lead to predictable results. A strict literal view would have included the note involved in that case within the securities acts.

187. See notes 16-30 and accompanying text *supra*.

188. See note 186 *supra*.

189. See notes 16-30 and accompanying text *supra*.