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Rubin v. United States: Pledge of Stock as Collateral for a Commercial Loan is a "Sale" of a Security

RUBIN V. UNITED STATES: PLEDGE OF STOCK AS COLLATERAL FOR A COMMERCIAL LOAN IS A "SALE" OF A SECURITY

The Securities Act of 1933 (1933 Act)[1] and the Securities Exchange Act of 1934 (1934 Act)[2] provide a cause of action for fraudulent securities transactions.[3] In order to satisfy the subject matter jurisdiction requirements of the federal anti-fraud securities laws, a plaintiff must demonstrate that the transaction sued upon involves a "sale"[4] or a "pur-

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[1] 15 U.S.C. §§ 77a-77bbbb (1976).

[2] 15 U.S.C. §§ 78a-77lll (1976).

[3] 15 U.S.C. § 78q(a) (1976); 15 U.S.C. § 78j(b) (1976). Section 17(a) of the 1933 Act provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce by the use of the mails, directly or indirectly—
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> (1) to employ any device, scheme, or artifice to defraud, or
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> (2) to obtain money or property by means of any untrue statement of a material fact or any omission 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
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> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. 15 U.S.C. § 77q(a) (1976).

Section 10(b) of the 1934 Act states:

> 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—
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> . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. § 78j(b) (1976).

Rule 10b-5, promulgated by the Securities Exchange Commission under section 10b of the 1934 Act, provides:

> 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,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (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 light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1980).

[4] *See* 15 U.S.C. § 77b(3) (1976); 15 U.S.C. § 78c(14) (1976). The 1933 Act defines a "sale" as "every contract of sale or disposition of a security or interest in a security for value." 15

chase"[5] of a security. The determination whether a transaction involves a "sale or purchase" is difficult because the definitional sections of the 1933 and 1934 Acts are broad and ambiguous.[6] The difficulties commonly arise in cases involving a pledge of stock as collateral for a commercial loan.[7] The Supreme Court, however, recently held in *Rubin v. United*

U.S.C. § 77b(3) (1976). Under the 1934 Act, a sale includes "any contract to sell or otherwise dispose of." 15 U.S.C. § 78c(14) (1976). Courts construe the two definitions as functional equivalents. *See* Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1040-41 (7th Cir. 1979) (citing National Bank of Commerce of Dallas v. All Am. Assurance Co. 583 F.2d 1295, 1298 (5th Cir. 1978)).

[5] *See* 15 U.S.C. § 78c(13) (1976). Under the 1934 Act, a "purchase" includes "any contract to buy, purchase or otherwise acquire." *Id.* The 1933 Act does not contain a definition of "purchase." Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1040 (7th Cir. 1979).

If a court holds that there is no sale or purchase, no federal subject matter jurisdiction exists. *See* National Bank of Commerce of Dallas v. All Am. Assurance Co., 583 F.2d 1295, 1298-1300 (5th Cir. 1978). A plaintiff must then seek relief under state "blue sky" laws or state common law. *See, e.g.*, 3 VA. CODE §§ 13.1-13.1-574 (1978 Repl. Vol.). *See generally* L. LOSS & E. COWETT, BLUE SKY LAW (1958). Plaintiffs prefer to seek relief under the federal securities laws because of certain advantages inherent in the federal anti-fraud provisions. *See* 5 A. JACOBS, THE IMPACT OF RULE 10B-5, § 11.01 (1974) [hereinafter cited as JACOBS]; Note, *Securities Regulation—Antifraud Provisions*, 11 CUM. L. REV. 237, 241 n.29 (1980) [hereinafter cited as *Securities Regulation*]; Note, *Rule 10b-5: The Circuits Debate the Exclusivity of Remedies, the Purchaser-Seller Requirement, and Constructive Deception*, 37 WASH. & LEE L. REV. 877, 889 n.95 (1980) [hereinafter cited as *Debate*]. The advantages of federal laws include nationwide venue and service of process, relaxed privity requirements, more liberal procedural rules, the elimination or modification of the traditional elements of common law fraud under the federal law. *See* White v. Abrams, 495 F.2d 724, 730-31 (9th Cir. 1974); Comment, *The Pledge and the Purchase and Sale Requirement of Section 10(b) and Rule 10b-5*, 65 GEO L.J. 1593, 1594 n.5 (1977) [hereinafter cited as *Pledge and Purchase and Sale Requirement*].

[6] *See* United States v. Naftalin, 441 U.S. 768, 773 (1977) (citing H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933)).

[7] *See, e.g.*, National Bank of Commerce of Dallas v. All Am. Assurance Co., 583 F.2d 1295, 1298-1300 (5th Cir. 1978); Rispo v. Spring Lake Mews, Inc., 485 F. Supp. 462, 466-68 (E.D. Pa. 1980). The issue whether a sale of a security is present also occurs in cases concerning misappropriation of securities and the "sale" of promissory note. *See, e.g.*, SEC v. Continental Commodities Corp., 497 F.2d 516, 528 (5th Cir. 1974) (delivery of a note in exchange for valuable consideration of a "sale"); Superintendent of Ins. v. Freedman, 443 F. Supp. 628, 634 (S.D.N.Y. 1977) (misappropriation of money authorized to purchase securities not a "purchase"); JACOBS, *supra* note 5, § 38.02.

A pledge is a bailment of personal property for the purpose of securing a loan or other obligation. *See* R. BROWN, THE LAW OF PERSONAL PROPERTY § 15.1 (3d ed. 1975) [hereinafter cited as BROWN]. In a pledge transaction, the person pledging the stock (pledgor) retains legal title to the pledge property, and the person receiving the pledge (pledgee) has possession of the pledged property as well as the right to dispose of the property upon the pledgor's default on the loan. *Pledge and the Purchase and Sale Requirement, supra* note 5, at 1593 n.1 (1977); Comment, *Applicability of Rule 10b-5 to Pledges of Securities*, 68 CALIF. L. REV. 547, 548 n.6 (1980) [hereinafter cited as *Applicability of Rule 10b-5*]. A pledge of stock commonly occurs when an individual or corporation obtains a loan and pledges shares of stock to the lender as collateral for the loan. *See Pledge and the Purchase and Sale Requirement, supra* note 5, at 1593; Comment, *Pledged Securities—The Pledgee's Duty to Preserve Value Under the Uniform Commercial Code*, 62 MARQ. L. REV. 391, 391 (1979) [hereinafter cited as *Pledgee's Duty*].

States[8] that pledges of stock as loan collateral satisfy the jurisdictional requirements of the anti-fraud provisions of the federal securities laws.[9]

Prior to *Rubin*, courts have applied either a literal statutory approach[10] or a title analysis[11] in determining whether a pledge of stock as collateral for a loan constitutes a sale of a security. Courts using a title analysis consistently determine that a pledge of stock is not a sale.[12] Under the title analysis, a sale occurs when title to the stock is transferred from the pledgor to the pledgee.[13] In an unforeclosed pledge of stock—,

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[8] 101 S. Ct. 698 (1981).

[9] 101 S. Ct. at 701.

[10] *See* Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1029 (6th Cir. 1979); Mallis v. Federal Deposit Ins. Corp., 568 F.2d 824, 829 (2d Cir. 1977), *cert. granted*, 431 U.S. 928 (1977), *cert. dismissed as improvidently granted*, 435 U.S. 381 (1978); United States v. Gentile, 530 F.2d 461, 466-67 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976). In *Mansbach*, the plaintiff alleged that a broker-dealer converted his corporate bonds which had been pledged as collateral for securities. 598 F.2d at 1021. The *Mansbach* court, noting a split of authority on the issue whether a pledge of stock constitutes a sale of a security, adopted the literal statutory view and held that the pledge did not constitute a sale. *Id.* 1029.

Gentile involved a criminal prosecution for conspiracy to violate federal securities laws and violation of securities laws arising from the pledge of wrongfully completed stock certificates. 530 F.2d at 463. The Second Circuit noted that a disposition of an interest in a security had occurred and therefore a sale was present. *Id.* at 466. The *Mallis* court relied on the statutory language of the 1934 Act and held that a pledge of stock disposes of an interest in a security. 568 F.2d at 829-30. The court construed the pledge as a sale, thereby providing the necessary subject matter jurisdiction. *Id.* at 830.

[11] *See* National Bank of Commerce of Dallas v. All Am. Assurance Co., 583 F.2d 1295, 1299-1300 (5th Cir. 1978); McClure v. First Nat'l Bank of Lubbock, Tex., 597 F.2d 490, 496 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975). In *McClure*, plaintiff was one-half owner of Gains County Development (GCD). 497 F.2d at 491. Plaintiff's ex-husband, also a half-owner of GCD, obtained plaintiff's consent to a 200,000 dollar loan on behalf of GCD, the proceeds of which were used to pay off personal debts. *Id.* at 492. In refinancing the loan, plaintiff pledged GCD stock as collateral for the loan. The bank foreclosed on the corporation's land, rendering plaintiff's stock worthless. Plaintiff brought an action under § 10(b) of the 1934 Act and rule 10b-5, alleging fraud in the sale of the securities. Using the title analysis, the Fifth Circuit affirmed the lower court's dismissal of the suit on the alternative ground that an unforeclosed pledge of stock as collateral did not constitute a sale under section 10(b). The court held that title to the stock must change hands to constitute a sale. Since an unforeclosed stock pledge does not transfer title, the court maintained the transaction did not constitute a sale. *Id.* at 496. The court further noted that the pledge transaction had no effect on the securities industry, and is therefore outside the purview of the federal securities acts. *Id.* at 495.

The defendant insurance company in *National Bank* pledged worthless stock as collateral for a 2.5 million dollar loan. 583 F.2d at 1297. Ultimately, the insurance company went bankrupt, resulting in a 1,450,000 dollar loss for plaintiff bank. *Id.* The Fifth Circuit held that the unforeclosed pledge of stock did not constitute a sale under § 10(b) of the 1934 Act and dismissed the case for lack of federal jurisdiction under the title analysis. *Id.* at 1302. The court's rationale for the decision is that an unforeclosed transaction does not transfer title to the stock and does not affect the rights and privileges of the parties involved. *Id.*

[12] *See* note 11 *supra*.

[13] *See* McClure v. First Nat'l Bank of Lubbock, Tex., 497 F.2d 490, 496 (5th Cir. 1974).

title to the stock remains in the pledgor.[14] The pledgor retains all rights and privileges in the stock even though the pledgee has actual possession of the stock.[15] Since title to the stock does not pass to the pledgee, no sale of a security occurs under the title analysis.[16]

Under the literal statutory approach, courts closely scrutinize the statutory language of the securities acts' definitional sections.[17] The definition of a "sale" in the 1933 Act includes any disposition of an interest in a security.[18] Since the transfer of any interest will satisfy the definitional requirements, the "sale" definition eliminates the requirement that title to the stock pass from the pledgor to the pledgee for a sale to occur.[19] In a pledge, the delivery of stock to the pledgee constitutes the dispostion of an interest in a security since the delivery gives the pledgee a perfected security interest in the stock.[20] Under the literal statutory analysis, therefore, a pledge constitutes a "sale" of a security.

Courts employing the title and statutory analyses consider the impact of pledge transactions on the implementation of the legislative purpose of the federal securities laws.[21] Although both analyses recognize that the purpose of the Acts are to protect investors, the analyses reach

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[14] *Id.* In *McClure*, the Fifth Circuit noted that a pledge could qualify as a sale upon foreclosure of the stock. *Id.* at 495. If a bank forecloses and sells unregistered stocks, the transaction would qualify as a sale and impose underwriter liability on the seller-bank. *See* National Bank of Commerce of Dallas v. All Am. Assurance Co., 583 F.2d 1295, 1297 (5th Cir. 1978); SEC v. Pig'n Whistle Corp., 359 F. Supp. 219, 211 (N.D. Ill. 1973); SEC v. National Bankers Life Ins. Co., 334 F. Supp. 444, 456 (N.D. Tex. 1971), *aff'd*, 477 F.2d 420 (5th Cir. 1973). *See also* Bosse v. Crowell, Collier and MacMillan, 565 F.2d 602, 611-12 (9th Cir. 1977). *See generally* Note, *A Pledge of Stock in a Commercial Loan: "Purchase or Sale" Under the Securities Exchange Act of 1934*, 1979 ARIZ. ST. L.J. 669.

[15] *See* note 7 *supra*; National Bank of Commerce of Dallas v. All Am. Assurance Co., 583 F.2d 1295, 1300 (5th Cir. 1978). A pledgor of stock retains the right to sell the stock, vote the stock, receive dividends, and remains liable for *ad valorem* taxes. *See Applicability of Rule 10b-5*, *supra* note 7, at 548 n.6.

[16] *See* McClure v. First Nat'l Bank of Lubbock, Tex., 497 F.2d 490, 496 (5th Cir. 1974).

[17] *See* Mansbach v. Prescott, Ball & Turben, 589 F.2d 1017, 1029 (6th Cir. 1979); United States v. Gentile, 530 F.2d 461, 466 (2d Cir. 1976); notes 3-5 *supra*.

[18] *See* notes 3 & 4 *supra*.

[19] *See* United States v. Gentile, 530 F.2d 461, 466 (2d Cir. 1976); text accompanying note 13 *supra*.

[20] *See* U.C.C. § 9-305 (1978 version). Under § 9-105(g) of the Uniform Commercial Code, the pledged stock certificates constitute "instruments." U.C.C. § 9-105(i) (1978 version). Thus, under § 9-305, the pledgee can perfect his security interest in the stock without filing a financing statement by taking possession of the stock. U.C.C § 9-305 (1978 version); J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 933-35 (2d ed. 1980). The perfected security interest gives the pledgee the right to sell the stock upon pledgor's default to satisfy pledgor's debt. *See* Pauly v. State Loan Ins. & Trust Co., 165 U.S. 606, 622 (1897).

[21] *See* National Bank of Commerce of Dallas v. All Am. Assurance Co., 583 F.2d 1295, 1300 (5th Cir. 1978); United States v. Gentile, 530 F.2d 461, 467 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976); McClure v. First Nat'l Bank of Lubbock, Tex., 497 F.2d 490, 495 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975).

opposite conclusions as to whether federal coverage of pledge transactions furthers the legislative purpose.[22] Under the title analysis, a pledge is considered an ordinary commercial transaction.[23] Since no investors are involved in a commercial transaction, the extension of federal antifraud coverage to pledge transactions therefore would have no impact on the protection of investors.[24]

Under the statutory analysis, however, the pledgee-bank is an investor. By accepting the pledge as collateral, the bank assumes the substantial risk that the stock will retain its original value.[25] Courts employing the statutory analysis equate this risk with the risk an investor takes.[26] Coverage of pledges by the securities acts is therefore appropriate under the statutory approach since the pledgee-bank is arguably an "investor" in the pledge stock.[27]

The Supreme Court considered both the title analysis and the literal statutory approach in *Rubin v. United States*[28] and held that a pledge of stock as collateral for a loan constituted an "offer or sale" under section 17(a) of the 1933 Act.[29] In *Rubin*, petitioner was an officer of Tri-State Energy, Inc., a corporation specializing in energy development.[30] In response to substantial financial pressures, Tri-State sought loans from Bankers Trust Company. The bank loaned Tri-State 50,000 dollars with

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[22] *Compare* National Bank of Commerce of Dallas v. All Am. Assurance Co., 583 F.2d 1295, 1300 (5th Cir. 1978) *with* Mallis v. Federal Deposit Ins. Corp., 568 F.2d 824, 829 (2d Cir. 1977) citing United States v. Gentile, 530 F.2d 461, 467 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976).

[23] *See* National Bank of Commerce of Dallas v. All Am. Assurance Co., 583 F.2d 1295, 1300 (5th Cir. 1978).

[24] *Id.* The Fifth Circuit's observation concerning the effect of the pledge transaction on the securities industry is an adaptation of the commercial/investment dichotomy used to determine whether an instrument is a security. *See* McClure v. First Nat'l Bank of Lubbock, Tex., 497 F.2d 490, 495 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975). A transaction is "investment" oriented if a person invests his money for the purpose of receiving a profit. *See* C.N.S. Enterprises, Inc. v. G&G Enterprise, Inc., 508 F.2d 1354, 1359 (7th Cir. 1975). A profit motivated investment transaction warrants federal security act coverage. *Id.* at 1363. An ordinary commercial transaction, however, is not within the purview of federal securities provisions. *Id.*

[25] United States v. Gentile, 530 F.2d 461, 467 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976). The Second Circuit noted that Congress intended the federal securities acts to protect defrauded lenders as well as defrauded buyers. *Id.*

[26] *Id.*; *see* Mallis v. Federal Deposit Ins. Corp., 568 F.2d 824, 824 (2d Cir. 1977).

[27] Mallis v. Federal Deposit Ins. Corp., 568 F.2d 824, 829 (2d Cir. 1977); United States v. Gentile, 530 F.2d 461, 467 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976).

[28] 101 S. Ct. 698 (1981).

[29] *Id.* at 699. *Rubin* is the first case in which the Supreme Court has examined the issue of federal securities law coverage for collateral stock pledge transactions. *See Applicability of Rule 10b-5*, *supra* note 7, at 557. The Court originally granted certiorari in Bankers Trust Co. v. Mallis, 431 U.S. 928 (1977). The Court, however, dismissed the writ of certiorari as improvidently granted subsequent to an inconsistent concession by petitioner's counsel in oral argument. 435 U.S. 381 (1978).

[30] 101 S. Ct. at 694.

the possibility of future loans contingent upon a production of financial information by Tri-State. The financial statement which Tri-State subsequently provided Bankers Trust was misleading because the statement included inflated earnings projections and an exaggerated net worth.[31] On the basis of the misleading financial statement, Bankers Trust provided Tri-State with an additional 425,000 dollars.

As a collateral for the loans, Tri-State pledged stock in various companies apparently valued at 1.7 million dollars, but which were actually worthless.[32] Subsequently, Bankers Trust demanded full payment of the loans. When Tri-State failed to make payment of the loans, Bankers trust sued Tri-State on a promissory note executed in conjunction with the loans.[33] The Justice Department later indicted Rubin on counts of violating and conspiring to violate section 17(a) of the 1933 Act as well as other federal anti-fraud statutes. Rubin appealed his conviction on the conspiracy count, urging that the pledge of stock as collateral for a bank loan did not constitute an "offer or sale" under the terms of section 17(a).[34]

In addressing the issue whether the pledge in question constituted a sale, the Supreme Court adopted the literal statutory analysis and focused on the plain language of the 1933 Act.[35] The Court first noted that the definition of a "sale" in section 2(3) of the 1933 Act included any disposition of a security or interest in a security.[36] The pledge agreement in *Rubin* transferred to Bankers Trust the right to dispose of the pledged stock upon Tri-State's default on the loans.[37] Accordingly, the Court ap-

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[31] *Id.* at 699. Included in the projected earnings were estimated returns from sham contracts and other forged documents. *Id.* Rubin also made bribes to bank officers totalling 5,000 dollars, ostensibly to induce the bank to grant subsequent loans to Tri-State. *Id.*

[32] *Id.* at 700. Tri-State did not own most of the stock it pledged. *Id.* Tri-State "rented" stock certificates from their owners to show to the bank and went so far as to have fictitious quotations made in an over-the-counter reporting service. *Id.* Much of the stock owned by Tri-State was issued by "shell" companies. *Id.*

[33] *Id.* Bankers Trust also sued Rubin personally on the grounds that he guaranteed the loans, and recovered a small percentage of its loss. *Id.*

[34] *Id.*

[35] *Id.* at 701; *see* text accompanying notes 17-20 *supra*. The *Rubin* Court observed that the statutory language does not control if there is a contrary expression of legislative intent. *Id.* at 701. The Court noted that Congress adopted the definition of a "sale" from the Uniform Sale of Securities Act, a model "blue sky" statute, which defined a sale as including "every disposition, or attempt to dispose of a security or interest in a security for value." *Id.* at 702 n.7. Prior to the enactment of the 1933 Act, one court held that a pledge of stock constituted a sale under the Uniform Sale of Securities Act definition. *Id.* at 702; *see* Cecil B. De Mille Productions, Inc. v. Woolery, 61 F.2d 45, 50 (9th Cir. 1932) (pledge of oil contracts as collateral for a loan constituted a "sale" under Uniform Sale of Securities Act). Since the petitioner in *Rubin* offered no evidence to suggest that Congress intended the definition of a sale to have a different import under the 1933 Act, the Court held that the statutory language controlled. 101 S. Ct. at 702.

[36] *See* 101 S. Ct. at 701; note 4 *supra*.

[37] *See* 101 S. Ct. at 701; note 6 *supra*. The Court implicitly rejected the title analysis premise that actual foreclosure must occur for a pledge transaction to constitute a sale. *See* note 14 *supra*.

plied the statutory analysis and held that the disposition of this interest by the pledgor was sufficient to bring the pledge transaction under the purview of section 17(a) provisions regulating the fraudulent sale of securities.[38]

In *Rubin*, the Supreme Court indicated that the classification of a pledge of stock as a sale under the 1933 Act was consistent with the legislative purpose of that Act.[39] The Court observed that Congress designed section 17(a) to ensure the veracity of information involved in the trading of securities.[40] The Court noted that a pledgee-bank, like an investor, relies upon the truthfulness of representations a pledgor makes concerning shares of pledged stock.[41] The Court, therefore, held that the inclusion of a pledge transaction within the purview of section 17(a) furthered the purpose of ensuring the integrity of investment security transactions.[42]

The literal statutory analysis of the issue whether a pledge of stock is a "sale," is a departure from the Court's analysis of the analogous issue whether an interest constitutes a "security" under the federal securities acts.[43] To determine whether a particular interest is a "secur-

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[38] 101 S. Ct. at 701. The *Rubin* Court rejected the notion that a transfer of title is necessary for a sale to occur. *Id.* The Court cited United States v. Gentile, 530 F.2d 461, 466 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976), for the proposition that the disposition of an interest in a security less than title would suffice for "sale" purposes. 101 S. Ct. at 701. *See* text accompanying 14 *supra*.

[39] 101 S. Ct. at 702.

[40] *Id.*

[41] *Id.* The Court equated the risk a pledgee takes that the pledged stock will retain its value with the risk an investor takes when buying a security. *Id.*; *see* United States v. Gentile, 530 F.2d 461, 467 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976).

[42] 101 S. Ct. at 702.

[43] The 1933 Act defines a "security" as follows:

> 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) (1976).

The 1934 Act defines a "security" in section 78(c):

> 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

ity" for purpose of federal anti-fraud coverage, the Supreme Court has employed an economic realities approach based on the substance rather than the form of a transaction.[44] In order to characterize the substance of

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grace, or any renewal thereof the maturity of which is likewise limited. 15 U.S.C. § 78c(10) (1976).

Congress intended the language of the two definitions to be similar, and courts treat the definitions as essentially equal. *See* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); S. REP. No. 792, 73d Cong., 2d Sess. 14 (1934).

The question what is a "security" is analogous to the issue whether a pledge is a "sale." Both issues involve scrutiny of broad definitional sections of the securities acts. *See* note 4, *supra.* Also, the determination of whether an interest is a "security" under the federal securities laws is similar to a "sale" investigation "to the extent that it demands resolution of the proper scope of the securities laws." Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1041 (7th Cir. 1979). Furthermore, the determination that a security is present has the same jurisdictional impact as a holding that a sale has occurred since no subject matter jurisdiction exists under the security acts if a transaction does not involve a security. *See, e.g.*, Fulk v. Bagley, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,640 (M.D.N.C. 1980) (subject matter jurisdiction not apparent since factual inquiry is necessary to determine whether employee benefits plan is a "security"); American Fletcher Mortgage Co. v. U.S. Steel Credit Corp., 635 F.2d 1247 (7th Cir. 1980) (subject matter jurisidiction lacking since loan participation not a security); Newton, *What Is a Security?: A Critical Analysis*, 48 MISS. L. J. 167, 168 n.4 (1977) [hereinafter cited as *Critical Analysis*].

See generally Fitzgibbon, *What Is A Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893 (1980); Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW 1567 (1980); Stansburg & Bedol, *Interests in Employee Benefit Plans as Securities: Daniel (International Brotherhood of Teamsters v. Daniel, 99 S. Ct. 790) and Beyond*, 3 U. PUGET SOUND L. REV. 83 (1980).

" *See* International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 558 (1979); United Hous. Foundation, Inc. v. Forman, 421 U.S. 837, 849 (1975). In *Forman*, the Court held that shares of stock entitling purchasers to lease apartments in a state subsidized, non-profit housing cooperative did not constitute securities under the economic realities of the transaction. 421 U.S. at 847. Initially discounting the argument that the shares constituted "stock," the Court explicitly rejected the Second Circuit's literal statutory approach of the problem. *See* 421 U.S. at 848; Deacon and Pendergast, *Defining a "Security" After the Forman Decision*, 11 PAC. L. J. 213, 218 (1980). The Court instead noted that the shares lacked characteristics common to stock such as free negotiability and the possibility of appreciation in value and held that the shares were not stock under the "security" definition. *See* 421 U.S. at 849. The Court next considered the claim that the shares represented an "investment contract." *Id.* at 851; *see* SEC v. W.J. Howey, 328 U.S. 292, 298-99 (1946) ("investment contract" is any scheme involving "an investment of money in a common enterprise with profits to come solely from the efforts of others"). In dismissing the petitioners' contention, the Court noted that the petitioners made no investment for profit. 421 U.S. at 853. The petitioners bought the housing shares out of a desire for low cost housing. *Id.* at 859.

In *Daniel*, the Court examined whether a non-contributory, compulsory pension plan was a security under the federal securities acts. 439 U.S. at 553. As in *Forman*, the Court looked to the economic realities of the transaction and held that an employee's motivation in accepting employment is not the desire to invest in a pension plan, but rather the desire to earn a living. *Id.* at 561. The Court indicated that an employment contract is not a true investment contract under the *Howey* text. *Id.*

The *Rubin* Court's emphasis on the literal statutory language marks a change in the Court's analysis of federal securities acts definitional problems. *See Securities Regulation*, *supra* note 5, at 245. In *Forman*, the Court explicitly rejected a literal approach in defining a security. 421 U.S. at 849-50. Instead, the Court stated that since securities transactions

a transaction, the Court has focused on the economic inducement for the transaction as evidenced by the motivation of the parties involved.[45] If a person gives up a separable financial interest for the purpose of gaining profits, then the transaction is an investment transaction covered by the federal securities acts.[46] Conversely, a person who is motivated by concerns other than the possibility of profits is not an investor and therefore outside the coverage of the federal securities acts.[47]

The economic realities analysis is a sounder approach than either the literal statutory analysis or the title approach for determining whether a pledge of stock constitutes a sale under the federal securities acts. The economic realities test better implements the legislative intent of the 1933 and 1934 Acts[48] of protecting investors from fraud.[49] To further the purpose of the acts, any analysis of securities transactions therefore must identify "investors," as those persons Congress sought to protect because of their vulnerability to fraud. The economic realities approach correctly identifies investors by examining the motives of the parties involved.[50] Under the economic realities approach, a person who enters into a transaction with an expectation of profit qualifies as an investor

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were economic in character, Congress intended the application of the securities acts to turn on the economic realities underlying the transaction. *Id.* at 849; *see also* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); SEC v. W.J. Howey Co., 325 U.S. 293, 298 (1946). Furthermore, the Court noted that the Second Circuit is the only circuit that has not rejected a literal approach. 421 U.S. at 849.

[45] *See* International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 561 (1979); United Hous. Foundation v. Forman, 421 U.S. 837, 853 (1975).

[46] United Hous. Foundation v. Forman, 421 U.S. 837, 852-53 (1975). The *Forman* Court noted that the possibility of tangential "investment" benefits did not satisfy the economic realities test. *Id.* at 854-57. The Second Circuit held that shareholders derived profits from rental reductions resulting from the income derived from Co-Op City commercial facilities, from tax deductions, and from savings resulting from the subsidized nature of the development. Forman v. Community Services, Inc., 500 F.2d 1246, 1254-55 (2d Cir. 1974). The *Forman* Court held that these benefits did not constitute investment profits because the benefits were essential services, not returns on investments. 421 U.S. at 857.

[47] 421 U.S. at 858.

[48] *See* text accompanying notes 50-53 *infra.*

[49] *See, e.g.*, International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979); Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 35 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976); United Hous. Foundation, Inc. v. Forman, 421 U.S. 837, 849 (1975); Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1041 (7th Cir. 1979); S. REP. No. 47, 73d Cong., 1st Sess. ____ (1933).

In United States v. Naftalin, 441 U.S. 768 (1979), the Court recently examined the purpose of the securities acts. In *Naftalin*, the respondent engaged in fraudulent practices in the purchase of securities and was subsequently convicted under section 17(a) of the 1933 Act. *Id.* at 770-71. Respondent appealed his conviction on the grounds that his fraud injured a broker, not an investor. The respondent contended that the purpose of the securities acts was to protect investors and therefore the injury to the broker was not a violation of 17(a). *Id.* The Court rejected respondent's arguments and held that the purpose of the act was not limited solely to protecting investors, but was also intended to "achieve a high standard of business ethics . . . in every facet of the securities industry." 441 U.S. at 755, citing SEC v. Capital Gains Bureau. 375 U.S. 180, 186-87 (1963).

[50] *See* text accompanying notes 46-48 *supra.*

entitled to federal securities act protection.[51] Neither the literal statutory approach nor the title analysis, however, discriminates between investors and non-investors.[52] The title and statutory approaches instead concentrate on the mechanics of the transactions by focusing solely on the transfer of title or any interest in a security.[53] By failing to distinguish between investors and non-investors, the title and statutory analyses do not implement the Act's legislative purpose of protecting investors.

The economic realities approach is a more desirable analysis to the issue whether a pledge of stock is a sale than the statutory and title analyses because the realities approach is more flexible. Under the title or statutory approaches, a sale occurs whenever there is a transfer of title or a disposition of an interest in a security.[54] By focusing on the motivation of the parties, however, the economic realities analysis takes into account such factors as the economic setting of the transaction[55] and the expectations of the parties concerning federal securities law coverage.[56] A commercial setting for a transaction indicates that a party is not making an investment for profit.[57] The absense of an expectation by a party that federal securities laws apply to a transaction also mitigates the finding of an investment motive.[58] The realities analysis, therefore, enables a court to decide each case on the facts instead of requiring the court to apply a rigid, statutory or title-based analysis that can possibly lead to absurd results.

Under the economic realities approach, the pledge transaction in *Rubin* did not constitute a sale. In *Rubin*, the commercial setting of the pledge was entirely commercial since the pledge was made in the context of a commercial loan. The commercial nature of the pledge indicates

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[51] *Id.*

[52] *See* text accompanying notes 17-20 *supra.*

[53] *Id.* The effect of the failure to distinguish investors from non-investors is to extend federal securities act coverage to transactions unintended by Congress. *See* Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1042 (7th Cir. 1979). In *Herber*, the Seventh Circuit adopted a context over text analysis to determine whether a pledge of stock was a sale of a security. *Id.* at 1041. Although the court noted that a pledge qualifies as a sale under a strict reading of the securities acts' definitions, the court held that the economic realities controlled. *Id.* Since the pledge is a commercial transaction, the court held that protection of such a transaction would not serve the legislative purpose of protecting investors. *Id.*; *see generally* Comment, *Caveat Lender—Federal Securities Law Does Not Apply to a Commercial Loan Secured By A Pledge of Securities*, 56 CHI—KENT L. REV. 1227 (1980) [hereinafter cited as *Caveat Lender*].

[54] *See* text accompanying notes 18-20 *supra.*

[55] *See* note 11 *supra.*

[56] *See* United Hous. Foundation, Inc. v. Forman, 421 U.S. 837, 851 (1975). In *Forman*, the Court implied that if the parties to a transaction realistically expected that federal securities laws would apply to the transaction an investment motive would likely be present. *Id.*

[57] *See* text accompanying notes 45-48 *supra.*

[58] *See* note 57 *supra.*

that the parties could not realistically expect federal securities laws to apply. Furthermore, the motivation of the parties to the pledge was to secure a commercial loan.[59] Neither the pledgor nor the pledgee parted with a financial interest for the purpose of obtaining economic gain. Although the pledgee-bank took a risk that the pledge securities would retain their value, the risk was not in anticipation of profits.[60] Moreover, the presence of the risk that the stock will decline in value does not alter the commercial, non-investment nature of the transaction.[61] Consequently, in view of the economic realties, extension of federal securities act coverage to the pledge of stock in *Rubin* is inappropriate.

The effect of the *Rubin* decision is to extend the scope of federal securities anti-fraud protection. After *Rubin*, pledges of stock as collateral for commercial loans will constitute "sales" and therefore fall within the coverage of federal anti-fraud provisions. *Rubin*'s expansion of anti-fraud coverage is inconsistent with the recent trend of Supreme Court decisions limiting the scope of Securities Act coverage.[62] Moreover, the availability of adequate state remedies obviates the need for federal protection of pledges of stock.[63] The commercial nature of the pledge also necessitates the exclusion of stock pledges from the purview of federal securities law.[64] Nevertheless, the *Rubin* Court's treatment of a pledge of stock as a sale will have the desirable effect of discouraging fraudulent activities in connection with pledges of stock, making such pledges a commercially safe mode of securing loans.

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[59] *See* text accompanying notes 45-48 *supra*; Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1043 (7th Cir. 1979). The *Herber* court noted that the risk taken by the pledgee-bank in a pledge of stock as collateral is an ordinary commercial risk taken by all secured lenders. *Id.*

[60] *See id.* Upon the pledgor's default on a loan, the pledgor-bank must sell the pledged stock to satisfy the debt. U.C.C. § 9-504(1) (1978 version). The pledgee-bank has to account to the pledgor for any proceeds in excess of the debt. U.C.C. § 9-504(2) (1978 version). The pledgee-bank cannot benefit from any increase in the stock's value, and any investment in the stock for profit is therefore impossible. *See id.*

[61] *See* Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1043 (7th Cir. 1979).

[62] *See* Touche Ross & Co. v. Redington, 442 U.S. 560, 567 (1979) (no private cause of action under section 17(a) of the 1933 Act); Santa Fe Indus. v. Green, 430 US.. 462, 473-74 (1977) (10(b) fraud must be manipulative or deceptive); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (scienter necessary for 10(b) claim); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (10(b) coverage limited to actual purchases or sellers); *Securities Regulation, supra* note 5, at 246; *Caveat Lender, supra* note 54, at 1246 n.136.

[63] *See* Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1044 (7th Cir. 1979). Under § 9-504 of the Uniform Commercial Code, the pledgee-bank can sue the pledgor for any difference in value between the pledged stock and the amount of the debt. U.C.C. § 9-504(2) (1978 version). Furthermore, the pledgee-bank has a state common law remedy for fraud and a possible remedy under state "blue sky" laws. *See* note 5 *supra*.

[64] *See* text accompanying notes 46-48 & 60-62 *supra*.