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When Is A Security Not A Security? Promissory Notes, Loan Participations, And Stock In Close Corporations

WHEN IS A SECURITY NOT A SECURITY? PROMISSORY NOTES, LOAN PARTICIPATIONS, AND STOCK IN CLOSE CORPORATIONS

After nearly half a century, the proper interpretation of the statutory definition of a security in the Securities Act of 1933[1] ('33 Act) and the Securities Exchange Act of 1934[2] ('34 Act) remains uncer-

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[1] U.S.C. §§ 77a-77bbbb (1976). The statutory definition of a security in the Securities Act of 1933 ('33 Act) provides:

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

Id. at § 77b(1) (1976).

[2] 15 U.S.C. §§ 78a-78lll (1976). The Securities Exchange Act of 1934 ('34 Act) defines a security as follows:

> When used in this chapter, unless the context otherwise requires— . . .
>
> 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.

Id. at § 78(c)(10) (1976).

Although the statutory definition of a security under the '33 Act differs slightly from the statutory definition of a security under the '34 Act, the two definitions functionally are equivalent. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975) (definitions are synonymous for the acts' coverage); Tcherepnin v. Knight, 389 U.S. 332, 336, 342 (1967) (definitions virtually identical); S. REP. No. 792, 73d Cong., 2d Sess. 14 (1934) (definitions substantially identical). The definition of a security in the proposed Federal Securities Code, and in the Uniform Securities Act adopted in over 35 states, virtually is identical to the statutory definitions in the '33 and '34 Acts. *See* ALI FED. SECURITIES CODE § 299.53 (Proposed Official Draft, Mar. 15, 1978); UNIFORM SECURITIES ACT § 401(1), *reprinted in* BLUE SKY L. REP. (CCH) ¶ 4931, at 727 (1971).

In addition to the Securities Act of 1933 and the Securities Exchange Act of 1934, there are four other major federal securities statutes with similar definitions of a security. *See* Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbb (1976) (regulations for public offerings of trust indentures); Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79-79z-6

tain.[3] Supreme Court decisions interpreting the statutory definition of a security[4] have created unlimited opportunities for academic discussion.[5] Judges and practicing attorneys, however, struggle to harmonize academic theory with the realities of modern business transactions.[6] An examination of recent cases concerning whether promissory notes,[7] loan participations,[8] and stock in close corporations[9] are securities under the federal securities laws reveals that the confusion surrounding the definition of a security results from the use of different analyses by the courts to determine if a transaction involves a security.[10]

(1976) (protection for investors in security transactions involving public utility); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-80a-52 (1976) (regulations for investment corporations); Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1-80b-21 (1976) (regulations for brokerage firms and investment advisors).

[3] *See, e.g.*, Ivan Allen Co. v. United States, 422 U.S. 617, 642-43 (1975) (Powell, J., dissenting) (Supreme Court's use of term "security" is ambiguous and uncertain); FitzGibbon, *What Is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893, 895 (1980) [hereinafter cited as FitzGibbon] (definition of a security is "muddy"); Newton, *What Is A Security: A Critical Analysis*, 48 MISS. L.J. 167, 167 (1977) [hereinafter cited as Newton] (definition of a security is shrouded in ambiguity); Peloso & LaBella, *Determining If Discretionary Customer Accounts Are Securities*, 9 SEC. REG. L.J. 307, 307 (1932) [hereinafter cited as Peloso & LaBella] (definition of a security is elusive concept).

The legal foundations of the '33 and '34 Acts create much of the confusion surrounding the definition of a security. *See* FitzGibbon, *supra*, at 894-95. The acts largely are revisions of the law of contracts. *Id.* As contract law developed into branches identified by the nature of the items transferred or the nature of the relationships established, nineteenth century lawyers began to classify transactions as specific types, such as loans or partnerships. *Id.* at 894-95. *See generally* J. CHITTY, A PRACTICAL TREATISE ON THE LAW OF CONTRACTS (1st ed. 1842). Since the legal profession today no longer rigidly classifies transactions into specific types, definitions of a security that merely name particular instruments promote confusion in an area praised for its maturity and precision. FitzGibbon, *supra*, at 895.

[4] *See generally* Marine Bank v. Weaver, _____ U.S. _____, 50 U.S.L.W. 4285 (March 9, 1982) (certificate of deposit); International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979) (pension plan); United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975) ("stock" in housing project); Tcherepnin v. Knight, 389 U.S. 332 (1967) (dividends on profits); SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) (flexible fund annuity contracts); SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65 (1959) (variable annuity contracts); SEC v. W. J. Howey Co., 328 U.S. 293 (1946) (land sales and service contracts); SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943) (interests in land). *See also* text accompanying notes 41-58 *infra* (discussion of Supreme Court's analysis of a security).

[5] *See* Newton, *supra* note 3, at 167 (ambiguous definition of a security evokes entertaining legal pirouettes for academic discussion); Peloso & LaBella, *supra* note 3, at 307 (definition of a security is center of substantial commentary).

[6] *See* Peloso & LaBella, *supra* note 3, at 307 (definition of a security is center of inordinate amount of litigation).

[7] *See* text accompanying notes 66-104 *infra* (discussion of promissory note as securities).

[8] *See* text accompanying notes 105-41 *infra* (definition and discussion of loan participation agreements).

[9] *See* text accompanying notes 143-72 *infra* (discussion of the sale of entire businesses as securities).

[10] *See* text accompanying notes 149-55 *infra* (sale of stock in close corporation is

Courts use two types of analyses to determine if a transaction involves a security.[11] Some courts find a security present in a transaction simply by finding that the transaction involves an instrument expressly enumerated in the statutory definition.[12] Other courts look beyond the literal language in the statutory definition and examine the circumstances surrounding a transaction to determine if the federal securities laws apply.[13] The dichotomy in analyses of alleged securities transactions often results in an instrument being a security in one jurisdiction and not a security in another jurisdiction.[14] The severe consequences of violating the federal securities laws, however, demand a uniform interpretation of the statutory definition of a security.[15]

Current interpretations of the statutory definition of a security create uncertainty as to whether many arms-length business transactions involve a security.[16] Businessmen, unhappy with a financial transaction, often try to exploit the uncertainty surrounding the proper interpretation of the definition of a security by alleging violations of the federal securities laws.[17] For example, plaintiffs barred by contributory

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securities transaction under literal analysis); text accompanying notes 156-72 (sale of stock in close corporation is not securities transaction under substantive approach); text accompanying notes 67, 87-91, 149-55 *infra* (discussion of literal analysis of securities transactions); text accompanying notes 41-58, 69-86, 125-38, 156-72 *infra* (discussion of substantive analysis of securities transactions); note 14 *infra* (status of alleged securities transaction often depends on which jurisdiction decides issue).

[11] *See* text accompanying notes 67, 87-91, 108-16, 149-55 *infra* (literal approach to definition of a security); text accompanying notes 41-58, 69-86, 125-38, 156-72 *infra* (substantive approach to definition of a security).

[12] *See* text accompanying notes 67, 87-91, 108-16, 149-55 *infra* (literal application of statutory definitions of a security).

[13] *See* text accompanying notes 41-58, 69-86, 125-38, 156-72 *infra* (substantive approach to definition of a security).

[14] *Compare* Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989, 992 (5th Cir. 1969) (loan participation agreement is a security) *with* Union Planters Nat'l Bank v. Commercial Credit, 651 F.2d 1174, 1185 (6th Cir. 1981) (loan participation agreement not a security) *and* Robbins v. First Am. Bank of Va., [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,240 (N.D. Va. 1981) (loan participation not a security).

[15] *See* text accompanying notes 18-25 *infra* (penalties and civil liabilities for violation of '33 and '34 Acts).

[16] *See, e.g.*, Coffin v. Polishing Machs., Inc., 596 F.2d 1202, 1205 (4th Cir.) (sale of entire business is a security), *cert. denied*, 444 U.S. 868 (1979); Sanders v. John Nuveen & Co., 463 F.2d 1075, 1079-81 (7th Cir.) (promissory note is a security), *cert. denied*, 409 U.S. 1009 (1972); Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989, 991 (5th Cir. 1969) (loan participation is a security); Bartels v. Algonquin Properties, Ltd., 471 F.Supp. 1132, 1146-49 (D. Vt. 1979) (limited partnership interest in intended tax shelter is a security); SEC v. Paro, 468 F.Supp. 635, 643 (N.D.N.Y. 1979) (co-op advertising arrangement in mail advertising venture is a security); First Fed. Sav. & Loan Ass'n v. Mortgage Corp., 467 F. Supp. 943, 950 (N.D. Ala. 1979) (mortgage loan from savings and loan to real estate developer is a security), *aff'd*, 650 F.2d 1376 (5th Cir. 1981); NBI Mortgage Inv. Corp. v. Chemical Bank [1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,632 (S.D.N.Y. 1976) and [1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,066 (S.D.N.Y. 1977) (loan participation is a security).

[17] *See, e.g.*, International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 570 (1979) (plaintiff

negligence from recovery for common law fraud often try to use the '33 and '34 Acts' substantive[18] and procedural[19] advantages to impose liability

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alleged interest in pension plan is a security); Hamblett v. Board of Sav. & Loan Ass'n, 472 F.Supp. 158, 166-67 (N.D. Miss. 1979) (plaintiff alleged savings account passbooks and similar instruments issued by bank are securities); Cordas v. Specialty Restaurants, Inc., 470 F.Supp. 780, 784-86 (S.D.N.Y. 1979) (plaintiff alleged business lease in shopping center is a security); Berman v. Bache, Halsey, Stuart, Shields, Inc., 467 F.Supp. 311, 319-20 (S.D. Ohio 1979) (allegation that discretionary trading account in commodity futures is a security); Hendrickson v. Buchbinder, 465 F.Supp. 1250, 1254 (S.D. Fla. 1979) (allegation that bank passbooks and similar documents are securities); Principe v. McDonald's Corp., 463 F.Supp. 1149, 1151 (E.D. Va. 1979) (plaintiff alleged promissory notes connected with franchise agreement are securities); note 16 *supra* (arms-length business transaction subject to federal securities law); note 21 *infra* (securities laws are not remedies for loans gone awry).

[18] *See* Note, *Bank Loan Participations as Securities: Notes, Investment Contracts, and the Commercial/Investment Dichotomy*, 15 DUQ. L. REV. 261, 265-67 (1977) [hereinafter cited as *Bank Loan*] (substantive advantages of federal securities laws include implied private right of action, relaxed proof of fraud, reliance and causation, extended liability for controlling persons, and possible attorney fees awards). Courts have implied a private right of action under both the '33 Act and '34 Act. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971) (implied private right of action under § 10b of 1934 Act); 1 A. BROMBERT, SECURITIES LAW; FRAUD—SEC RULE 10B-5 § 2.4(1) (1967) (private right of action under rule 10b-5) [hereinafter cited as BROMBERG]. *See generally* Simpson, *Investors' Civil Remedies Under the Federal Securities Laws*, 12 DEPAUL L. REV. 71 (1961). The Eastern District of Pennsylvania was the first court to imply a private right of action under § 10(b) of the '34 Act. *See* Kardon v. National Gypsum Co., 69 F.Supp. 512, 514 (E.D. Pa. 1946). Although courts still recognize private actions under rule 10b-5, recent Supreme Court decisions have limited the availability of rule 10b-5 actions. *See, e.g.*, Sante Fe Indus. v. Green, 430 U.S. 462, 477 (1977) (breach of fiduciary duty without deception not actionable fraud under rule 10b-5); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (plaintiff in private damage action under rule 10b-5 must make showing of scienter); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 738-39 (1975) (private plaintiff under rule 10b-5 must be purchaser or seller of security). *See generally* Lowenfels, *Recent Supreme Court Decisions Under The Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977); Note, *Judicial Retrenchment Under Rule 10b-5; An End To The Rule As Law*, 1976 DUKE L.J. 789.

Congress based the federal securities laws' antifraud provisions on the common law elements of fraud. Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 45-46 (2d Cir. 1978). To recover in a common law fraud action, a plaintiff must prove an intentional misrepresentation, reliance, causation, and damages. *See* Derry v. Peek, [1889] 14 A.C. 337, 374; RESTATEMENT OF TORTS § 551(1) (1938); W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 105 (4th ed. 1971) [hereinafter cited as PROSSER]. At common law, a plaintiff had to prove that a misrepresentation was made knowingly, or without belief in its truth, or recklessly without regard to its truthfulness. *See* PROSSER, *supra*, § 107. Although a plaintiff in a rule 10b-5 action must make some showing of scienter to recover damages, the exact amount of proof required is uncertain. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (plaintiff must make allegation of scienter to recover damages in 10b-5 action). *But see* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 (2d Cir. 1968) (no scienter required for security fraud action), *cert. denied*, 404 U.S. 1005 (1971).

The *Hochfelder* Court defined scienter as the intent to deceive, manipulate, or defraud. *Id.* at 194 n.12. The Court did not hold that a specific intent to deceive was necessary. *Id.* The Court held, however, that "mere negligence" by a defendant would not permit a plaintiff to recover damages. *Id.*; *see* Note, *Rule 10b-5 Liability after Hochfelder: Abandoning the Concept of Aiding and Abetting*, 45 U. CHI. L. REV. 218, 231 (1977). The *Hochfelder*

Court apparently precluded liability only for negligence and preserved common law recklessness as proof of scienter in 10b-5 actions. *See* Sante Fe Indus. v. Green, 430 U.S. 462, 471-74 (1977). *See generally* Berner & Franklin, *Scienter and Securities And Exchange Commission Rule 10b-5 Injunction Actions: A Reappraisal In Light Of Hochfelder*, 51 N.Y.U. L. REV. 769 (1976); Lowenfels, *Scienter or Negligence Required for SEC Injunctions under Section 10(b) and Rule 10b-5. A Fascinating Paradox*, 33 BUS. LAW. 789 (1978); Note, *SEC Enforcement Actions To Enjoin Violations Of Section 10(b) and Rule 10b-5: The Scienter Question*, 5 HOFSTRA L. REV. 831 (1977).

At common law, a person had no duty to voluntarily disclose material information unless he occupied a fiduciary position. *See* RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976). Rule 10b-5 actions now mirror common law fraud actions and impose a duty to disclose material information only when a fiduciary relationship exists between the parties. Chiarella v. United States, 445 U.S. 222, 227-28 (1980). Furthermore, a mere breach of fiduciary duty without deception or manipulation is not actionable fraud under the federal securities laws. Sante Fe Indus. v. Green, 430 U.S. 462, 474-77 (1977). Assuming, however, that the disclosure and the intent or scienter requirements for common law fraud and a rule 10b-5 action are the same, a rule 10b-5 action is more attractive to a plaintiff because proving reliance and causation is easier in a rule 10b-5 action. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) (proof of reliance and causation shifted to proof of materiality of omitted or misleading information); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (plaintiff in rule 10b-5 action must prove that reasonable man would attach importance to misleading information), *cert. denied*, 404 U.S. 1005 (1971). *See generally* BROMBERG, *supra*, § 8.6 (reliance), § 8.7 (causation).

Corporate officers, members of the board of directors, parent corporations, majority stockholders, and other controlling persons also may be liable for fraudulent activities under the securities acts. 15 U.S.C. § 78t(a) (1976); *see* Smith v. Bear, 237 F.2d 79, 87-89 (2d Cir. 1956) (partners in New York brokerage firm liable for California brokerage firm's rule 10b-5 violation); Hawkins v. Merrill Lynch, Pierce, Fenner & Beane, 85 F.Supp. 104, 109-10 (W.D. Ark. 1949) (brokerage firm liable for acts of wire correspondent). For a controlling person to incur liability, the person controlled does not have to be a defendant. Demarco v. Edens, 390 F.2d 836, 840 (2d Cir. 1968). Although the '34 Act does not directly define "controlling persons," the term clearly includes parent corporations, controlling stockholders, and agents' principals. *See* 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, 506 n.116 (1973) [hereinafter cited as *A Note Is A Note*]; *cf.* 17 C.F.R. § 230.405(f) (1981) (SEC rule 405(f) promulgated under '33 Act); ALI FED. SECURITIES CODE § 221 (Proposed Official Draft, Mar. 15, 1978).

An additional advantage to suing under the '34 Act is the possibility of recovering attorney's fees. *See* Mills v. Electric Auto-Lite Co., 396 U.S. 375, 389-97 (1970) (although not expressly authorized by 15 U.S.C. § 78n(a), successful party may recover attorney's fee under '34 Act); *cf.* Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 260-71 (1975) (Supreme Court overturned award of attorney's fees under Mineral Leasing Act, 30 U.S.C. § 185 (1976), stating general rule that party in federal litigation cannot recover attorney's costs).

[19] *See Bank Loan, supra* note 18, at 265-67 (federal securities laws provide for exclusive federal jurisdiction, nationwide venue and service of process, and do not require a plaintiff to post surety). The '33 and '34 Acts provide for exclusive federal jurisdiction. *See* Woodward v. Metro Bank of Dallas, 522 F.2d 84, 91 (5th Cir. 1975) (transaction must involve a security for federal jurisdiction under 1934 Act); Blackwell v. Bentsen, 203 F.2d 690, 691 (5th Cir. 1953) (transaction must involve a security for federal jurisdiction under '33 Act). Since state law fraud statutes require different standards of proof, exclusive federal jurisdiction provides a uniform standard of liability in all actions involving securities fraud. *Compare* ALA. CODE § 6-5-101 (1975) (innocent misrepresentation is actionable fraud) *with* GA. CODE ANN. § 51-6-2 (1981) (innocent misrepresentation is not actionable fraud). In addi-

for unprofitable transactions on the nearest deep pocket.[20] Congress, however, did not enact the federal securities laws to provide a cause of action for unhappy businessmen.[21]

Congress enacted the '33 and '34 Acts in response to the unscrupulous and abusive practices that caused the stock market crash of 1929.[22] Congress replaced *caveat emptor* with a philosophy of full disclosure in order to achieve a high standard of professional ethics in

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tion to exclusive federal jurisdiction, the '34 Act provides for nationwide venue and service of process. *See* 15 U.S.C. § 78aa (1976) (venue and service or process relaxed under federal securities statutes).

Plaintiffs suing under the federal securities acts do not have to post bonds for costs in advance. *See* McClure v. Borne Chem. Co., 292 F.2d 824, 830 (3d Cir.) (unlike stockholder derivative actions in many states, no posting of bond for costs required in federal securities action), *cert. denied*, 368 U.S. 939 (1961); *cf.* City Nat'l Bank v. Vanderboom, 422 F.2d 221, 225 (8th Cir.) (bond required for expenses in state law cause of action), *cert. denied*, 399 U.S. 905 (1970); Crowell v. Pittsburgh & L.E.R.R., 373 F. Supp. 1303, 1310 (E.D. Pa. 1974) (surety bond required for expenses in state law cause of action if not waived by court). Some states, however, require or allow a court to require a plaintiff in a stockholder derivative suit to post security for court costs and a defendant's expenses, including attorney fees. *See, e.g.*, CAL. CORP. CODE § 800 (West 1977); N.Y. BUS. CORP. LAW § 627 (McKinney Supp. 1981); *A Note Is A Note*, *supra* note 18, at 507-08; *cf.* MODEL BUSINESS CORPORATION ACT § 49 (1969) (requiring indemnification bond). Although § 11(e) of the '33 Act requires security for expenses, the provision need not apply if the plaintiff sues only under rule 10b-5 promulgated under the '34 Act. *See* U.S.C. § 77k(e) (1976) (security for expenses provision of '33 Act).

[20] *See* Union Planters Nat'l Bank v. Commercial Credit, 651 F.2d 1174, 1186 (6th Cir. 1981) (state fraud claim barred by contributory negligence so plaintiff alleged securities laws violations); note 17 *supra* (plaintiffs alleged securities laws violations to take advantage of uncertainty surrounding proper interpretation of definition of security).

[21] *See, e.g.*, Union Planters Nat'l Bank v. Commercial Credit, 651 F.2d 1174, 1185 (6th Cir. 1981) (securities laws are not panacea for commercial loans gone awry); Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1253 (9th Cir. 1976) (lawsuit over promissory note is just another way to convert § 10(b) of '34 Act into source of general federal jurisdiction); *accord*, Woodward v. Wright, 266 F.2d 108, 112 (10th Cir. 1959) (securities laws not intended to apply to all securities transactions because certain categories of transactions and securities excluded from laws' scope); Bangs, *Rule 10b-5 And The South Dakota Lawyer*, 14 S.D. L. REV. 56, 79 (1969) (rule 10b-5 is becoming most prolific source of litigation since Henry Ford invented the automobile); text accompanying notes 22-27 *infra* (congressional policy of federal securities laws).

[22] *See, e.g.*, United Hous. Found. v. Forman, 421 U.S. 837, 849 (1975); SENATE COMMITTEE ON BANKING AND CURRENCY, STOCK EXCHANGE PRACTICES, S. REP. NO. 1455, 73d Cong., 2d Sess. 81 (1934) [hereinafter cited as S. REP. NO. 1455]; H.R. REP. NO. 85, 73d Cong., 1st Sess.; L. LOSS, SECURITIES REGULATION 74-76 (1951) [hereinafter cited as LOSS]; Loomis, *The Securities Exchange Act of 1934 and the Investment Advisors Act of 1940*, 28 GEO. WASH. L. REV. 214, 214-19 (1959) [hereinafter cited as Loomis]; Newton, *supra* note 3, at 168.

The stock market crash of October 1929 abruptly ended an era of seemingly indefinite prosperity that followed World War I. LOSS, *supra*, at 75. Investors in the United States bought over $50 billion of securities from 1920 to 1933. *Id.* Over one-half of these securities were worthless by 1933. *Id.* The aggregate value of all stocks listed on the New York Stock Exchange was $89 billion on September 1, 1929. *Id.* By the end of October 1929, the aggregate value of all stocks listed on the New York Stock Exchange had fallen to $71 billion, a decrease of over $18 billion. *Id.* In 1932, the aggregate figure was only $15 billion. *Id.* In

the securities markets.[23] The acts attempt to protect the investing public from fraud and nondisclosure of relevant information[24] by providing penalties and remedies for fraudulent practices connected with the sale or purchase of a security.[25] Although the acts provide broad remedies for

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just two and one-half years, the aggregate value of all stocks listed on the New York Stock Exchange dropped by over $74 billion, or over 83 percent. *Id.*

Several factors prompted the crash. The primary factor was the extensive use of credit for speculation on small margins and the resulting mass sale of securities to meet margin calls on any decline in the market. Loomis, *supra*, at 217. Another factor was the manipulation of prices on the exchanges by pools of issuers and their management involved in short-term trading on inside information. *Id.* The failure of corporations listed on the exchanges to disclose material information to investors aggravated other defects in the operation of the market and greatly contributed to the crash by flooding the market with worthless and near-worthless securities. *Id.*; S. REP. No. 1455 *supra*.

[23] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 188-90 (1963). President Roosevelt's 1933 message to Congress concerning new securities legislation states that the proposed securities laws add to the ancient rule let the buyer beware, the further doctrine let the seller also beware. *See* H.R. DOC. No. 12, 73d Cong., 1st Sess. 1 (1933), *reprinted in* 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J. Ellenberger & E. Mahar eds. 1973), Item 15, at 1.

[24] *See, e.g.*, United Hous. Found. v. Forman, 421 U.S. 837, 849 (1975); SEC v. Sunbeam Gold Mines Co., 95 F.2d 699, 702 (9th Cir. 1938); SEC v. Gulf International Finance Corp., 223 F.Supp. 987, 989 (C.D. Fla. 1963); S. REP. No. 792, 73d Cong., 2d Sess. 3, 18 (1934); S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933); H.R. REP. No. 1383, 73d Cong., 2d Sess. 1 (1934). *See also* TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976) (information is relevant if substantial likelihood exists that reasonable shareholder would consider information important in making investment decision).

The '33 Act seeks to protect investors from losses incurred as a result of buying worthless securities by requiring issuers to disclose all relevant information concerning a new offering prior to sale. *See* 15 U.S.C. §§ 77e-77h, 77j (1976). The '34 Act requires full disclosure of relevant information concerning any subsequent sales of securities in secondary markets. *See* 15 U.S.C. §§ 77l-78n (1976).

The '33 Act imposes liability only for fraud on the part of sellers. 15 U.S.C. §§ 77a-77aa (1976); *see* 15 U.S.C. § 77k(a) (1976) (civil liability on persons involved in preparing registration statement); 15 U.S.C. §§ 77l(2), 77q(a) (1976) (liability on any person in the offer or sale of any security). The '34 Act, and rule 10b-5 promulgated thereunder, however, impose liability on both buyers and sellers of securities. 15 U.S.C. § 78j(b) (1976); 17 C.F.R. § 240.10b-5 (1981). Therefore, when an issuer sues a buyer for fraud, the action is exclusively under the 1934 Act. *See A Note Is A Note*, *supra* note 18, at 479 n.4.

[25] *See* 15 U.S.C. § 77q(a) (1976) (antifraud provision of '33 Act); 15 U.S.C. § 78j(b) (1976) (antifraud provision of the '34 Act). Section 17(a) of the '33 Act makes unlawful any device, scheme, practice, or artifice to defraud or to obtain money by means of an untrue statement or omission of a material fact in connection with the offer or sale of a security. *See* 15 U.S.C. § 77q(a) (1976). Rule 10b-5, promulgated by the Securities and Exchange Commission under § 10b of the '34 Act, contains proscriptions almost identical to the prohibitions in § 17(a) of the '33 Act. *See* 15 U.S.C. § 78j(b) (1976) (§ 10(b) of the '34 Act); 17 C.F.R. § 240.10b-5 (1981) (rule 10b-5); note 24 *supra* ('33 Act disclosure requirements apply to new offerings of securities while '34 Act disclosure requirements apply to secondary trading).

Under both the '33 Act and the '34 Act, no federal subject matter jurisdiction exists if there is not a sale or purchase of a security. *See* National Bank of Commerce of Dallas v. All Am. Assurance Co., 583 F.2d 1295, 1298-1300 (5th Cir. 1978). The '33 Act defines a "sale" as every contract for sale or disposition of a security or interest in a security for value. *See* 15

defrauded parties in securities transactions,[26] the acts do not apply to every financial transaction.[27]

The '33 and '34 Acts govern a transaction only if two requirements exist.[28] First, the transaction must involve interstate commerce or use of the United States mail.[29] Second, the transaction must involve a security.[30] Since most business transactions involve some form of interstate commerce or use of the mails,[31] and because the parties to a transaction cannot waive compliance with the provisions of the securities acts,[32] the presence of a security in a transaction often deter-

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U.S.C. § 77(b)(3) (1976). The definition of a sale in the '34 Act functionally is equivalent to the definition of a sale in the '33 Act. *See* Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1040-41 (7th Cir. 1979); National Bank of Commerce of Dallas v. All Am. Assurance Co., 583 F.2d at 1298; 15 U.S.C. § 78(c)(14) (1976) ('34 Act definition of sale). Although the '33 Act does not define "purchase," under the '34 Act, a purchase includes any contract to buy, purchase, or otherwise acquire a security. 15 U.S.C. § 78(c)(13) (1976). *See* 604 F.2d at 1040 (no definition of "purchase" in 1933 Act); Note, *Rubin v. United States: Pledge of Stock as Collateral for a Commercial Loan is a "Sale" of a Security*, 38 WASH. & LEE L. REV. 863, 863 n.4, 864 n.5 (1981) (discussion of definition of sale and purchase under '33 and '34 Acts and alternatives for plaintiffs if no sale or purchase exists). *See generally* Comment, *The Pledge And The Purchase And Sale Requirement Of Section 10(b) And Rule 10b-5*, 65 GEO. L.J. 1593 (1977).

[26] *See* notes 18 & 19 *supra* (federal securities laws provide expansive easily obtained remedies for defrauded parties in securities transactions).

[27] *See* text accompanying notes 18 & 19 *supra* (jurisdictional requirements under '33 and '34 Acts); note 17 *supra* (transactions not governed by federal securities laws).

[28] *See* text accompanying notes 29-30 *infra*.

[29] *See* U.S. CONST. art. 1, § 8. The United States Constitution expressly limits Congress' power over domestic commerce to interstate commerce. *Id.* The Constitution, therefore, impliedly limits all federal regulations concerning domestic commerce to interstate commerce. *See id.*

[30] *See, e.g.*, Union Planters Nat'l Bank v. Commercial Credit, 651 F.2d 1174, 1179 (6th Cir. 1981); Mifflin Energy Sources, Inc. v. Brooks, 501 F.Supp. 334, 334-35 (W.D. Pa. 1980); Titsch Printing, Inc. v. Hastings, 456 F.Supp. 445, 447 (D. Colo. 1978). *See also* Williamson v. Tucker, 645 F.2d 404, 412-17 (5th Cir.) (discussion of federal jurisdiction in securities cases), *cert. denied*, 102 S. Ct. 396 (1981).

[31] *See, e.g.*, Perez v. United States, 402 U.S. 146, 154 (1971) (local high interest loans subject to federal law); Katzenbach v. McClung, 379 U.S. 294, 302 (1964) (local restaurant subject to federal law because it purchased meat from a local supplier who purchased meat outside state); Wickard v. Filburn, 317 U.S. 111, 119-20 (1942) (farmer growing wheat for personal consumption subject to federal law); Western Waste Service Systems v. Universal Waste Control, 616 F.2d 1094, 1099 (9th Cir.) (hauling rubbish locally substantially affects interstate commerce), *cert. denied*, 449 U.S. 869 (1980); Chatham Condominium Ass'n v. Century Village, Inc., 597 F.2d 1002, 1008-09 (5th Cir. 1979) (unlawful tying arrangement subject to federal regulation); Doctors, Inc. v. Blue Cross of Greater Philadelphia, 490 F.2d 48, 53-55 (3d Cir. 1973) (local boycott to limit competition subject to federal law).

[32] *See* 15 U.S.C. § 78cc(a) (1976) ('34 Act antiwaiver provision); 15 U.S.C. § 77n (1976) ('33 Act antiwaiver provision). In *Wilko v. Swan*, the Supreme Court voided an agreement to arbitrate future disputes between a brokerage house and its customers under the antiwaiver provision of the '33 Act. 346 U.S. 427, 432-35 (1953); *see* Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 182-83 (2d Cir.) (very likely that antiwaiver provision of 1934 Act would have same construction as antiwaiver provision of 1933 Act), *cert. denied*, 385 U.S. 817 (1966).

mines whether the acts apply. With the relative ease of recovery under the acts,[33] the type of analysis a court applies to determine if a transaction involves a security often determines whether a plaintiff can recover damages at all.[34]

I. INVESTMENT CONTRACTS

Both the '33 Act and the '34 Act define a security by listing instruments commonly considered securities.[35] Congress included generic terms such as "investment contract" in the statutory definitions to insure that the acts governed all instruments with the characteristics of securities.[36] Language preceding the statutory definitions, however, states that an instrument is a security unless the context requires otherwise.[37] The securities acts, therefore, may not apply if the parties to a transaction did not use an instrument in the normal context of a securities transaction, even though the parties to the transaction labeled the instrument as a security, or the instrument commonly is known as a security.[38] Although some courts ignore the language preceding the statutory definitions and hold that an instrument is a security simply by finding the instrument's label listed in the statutory definition,[39] most courts reject this literal approach and examine the circumstances surrounding an alleged securities transaction to determine if the securities acts apply.[40]

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[33] *See A Note Is A Note*, *supra* note 18, at 504-06 (comparative ease of recovery under rule 10b-5); text accompanying notes 18 & 19 *supra* (requirements for recovery under 10b-5).

[34] *See Bank Loan*, *supra* note 18, at 266-67 (classification of security might determine if plaintiff recovers at all).

[35] *See* notes 1 & 2 *supra* ('33 and '34 Acts' definition of a security).

[36] *See* H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933) (security defined in sufficiently broad and general terms so as to include instruments known as securities); Long, *An Attempt To Return "Investment Contracts" To The Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 138 (1971) [hereinafter cited as Long] (investment contract definition protects investors from schemes with the characteristics of a security); notes 1 & 2 *supra* (statutory definitions of a security).

[37] *See* notes 1 & 2 *supra* (precatory language to statutory definitions).

[38] *See* note 40 *infra* (substantive analysis of alleged securities transaction). *See also* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849-57 (1975) (substantive analysis adopted by Supreme Court for examining alleged securities transactions).

[39] *See* Union Planters Nat'l Bank v. Commercial Credit, 651 F.2d 1174, 1180 n.7 (6th Cir. 1981) (discussion of literal approach to definition of a security); Exchange Nat'l Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1137-38 (2d Cir. 1976) (literal approach applied to notes); Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989, 992 (5th Cir. 1969) (literal approach applied to loan participation).

[40] *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851 (1975) (instruments labeled "stock" by parties to transaction not securities); McClure v. First Nat'l Bank, 352 F. Supp. 454, 468 (N.D. Tex. 1973) (notes not securities), *aff'd*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); Joseph v. Norman's Health Club, Inc., 336 F.Supp. 307, 313 (E.D. Mo. 1971) (notes not securities); *accord*, Union Planters Nat'l Bank v. Commercial Credit, 651 F.2d 1174, 1180 (6th Cir. 1981) (literal inclusion of instrument in statutory definition is not dispositive of finding a security). *But see* Lehigh Valley Trust Co. v. Central Nat'l Bank,

In *SEC v. W. J. Howey Co.*,[41] the Supreme Court adopted a substance-over-form analysis for examining an alleged securities transaction. In *Howey*, the Court held that sales contracts for plots of farm land and service contracts to harvest fruit trees on the land were securities under the federal securities laws.[42] The Court examined the circumstances or "economic realities" of the transaction to determine if the sales and service contracts were investment contracts within the statutory definition of a security.[43] The *Howey* Court held that an investment contract is any contract, transaction, or scheme in which a person invests money in a common enterprise and expects profits solely from the work of a third party.[44] The Court held that the sales and service contracts were investment contracts under the '33 Act because the promoters of the land attracted buyers solely by the chance of a return on the buyer's investment, and the buyers did not intend to occupy or develop the land themselves.[45]

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409 F.2d 989, 992 (5th Cir. 1969) (literal approach to definition of security applied to loan participation).

[41] 328 U.S. 293 (1946). In addition to *SEC v. W. J. Howey Co.*, the Supreme Court has decided several other cases dealing with the definition of a security. *See* note 4 *supra* (Supreme Court decisions concerning definition of a security).

[42] 328 U.S. at 301. In *Howey*, the Howey Company offered for sale to the public long strips of land that contained rows of citrus trees. *Id.* at 295. The company encouraged buyers to enter into ten year service contracts with the company to cultivate and harvest the buyer's trees. *Id.* at 296. The company told purchasers that the service contracts were not absolutely required, but that it was not feasible to profitably invest in the land without the service contracts. *Id.* at 295. Once a buyer signed a service contract, he had no right to specific fruit and received only a portion of the profits derived from the sale of fruit harvested from his plot. *See* SEC v. W. J. Howey Co., 151 F.2d 714, 717 (5th Cir. 1945), *rev'd*, 328 U.S. 293 (1946).

[43] 328 U.S. at 298. Although a person usually does not characterize the sale of land in conjunction with a service contract to harvest fruit on the land as a security transaction, the *Howey* Court found that such a transaction clearly was an investment contract because "something more" than a transfer of ownership in land was involved. *Id.* at 299. The Court held that the management and harvesting of the land was the primary value of the investment. *Id.* at 300.

[44] *Id.* at 298-99. The *Howey* Court primarily relied on State v. Golpher Tire & Rubber Co., 146 Minn. 52, 177 N.W. 937 (1920), in defining an investment contract. *See* 328 U.S. at 298. In *Golpher Tire*, the court defined "investment" for purposes of the definition of "investment contract" in the state's securities laws as the placing of capital or laying out of money in a way intended to secure income or profit from its employment. 177 N.W. at 938; *see* FitzGibbon, *supra* note 3, at 899 n.18.

[45] 328 U.S. at 300. The *Howey* Court concluded that because the elements of an investment contract existed, the sales and service contracts were securities within the statutory definition of a security in the '33 Act and, thus, the provisions of the '33 Act applied to the transaction. *Id.* Despite a wide following in lower courts, the *Howey* test became unpopular with many commentators. *See* Long, *supra* note 36, at 177 (*Howey* is "tragic"); *cf.* Tew & Freedman, *In Support of SEC v. W. J. Howey Co.: A Critical Analysis of the Parameters of the Economic Relationship between an Issuer of Securities and the Securities Purchaser*, 27 U. MIAMI L. REV. 407, 448 (1973) (commenting with regret that criticism of *Howey* is mark of progressive thought). *See also* FitzGibbon, *supra* note 3, at 899 n.20 (discussion of

Although the *Howey* Court defined only an investment contract,[46] in *United Housing Foundation, Inc. v. Forman*,[47] the Court stated that the *Howey* economic realities test embodies the essential attributes of all the Court's decisions defining a security.[48] In *Forman*, the Court applied the economic realities test to stock certificates that entitled a purchaser to live in publicly financed, low-income housing.[49] The Court held that the federal securities laws did not govern the instruments even though the parties to the transaction labeled the instruments "stock."[50] The Court noted that the instruments possessed none of the traditional characteristics associated with stock.[51] The instruments were not negotiable, could not be pledged or encumbered, conferred no voting rights, paid no dividends, and most importantly, could not realize a profit by increasing in value.[52]

The *Forman* Court stated that a court should examine the actual economic inducement of the parties and the underlying purpose of a

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subsequent history of *Howey* test). Courts, however, have applied the *Howey* test to a variety of instruments. *See, e.g.*, McCown v. Heidler, 527 F.2d 204, 208-09 (10th Cir. 1975) (*Howey* test applied to interests in real property); Swank Fed. Credit Union v. C. H. Wagner & Co., 405 F.Supp. 385, 388-89 (D. Mass. 1975) (*Howey* test applied to interests in oil and gas leases); *accord*, Braniff Airways, Inc. v. LTV Corp., 479 F.Supp. 1279, 1283-86 (N.D. Tex. 1979) (analysis of extent that *Howey* test applies to other instruments).

[46] *See* SEC v. W. J. Howey Co., 328 U.S. 293, 298-99 (1946) (economic realities test defines investment contract); FitzGibbon, *supra* note 3, at 899 n.20 (*Howey* Court was not defining security in general, but rather investment contract).

[47] 421 U.S. 837 (1975).

[48] *Id.* at 852. The *Forman* Court reaffirmed the *Howey* test's substance over form analysis and found no distinction between an "investment contract" and an "instrument commonly known as a security." *Id.*; *see* notes 1 & 2 *supra* (statutory definitions of a security).

[49] 421 U.S. at 860. In *Forman*, 57 residents of Co-op City brought a class action suit on behalf of 15,000 apartment owners in the same complex. *Id.* at 844. The plaintiffs sought over $30 million in damages and forced rental reductions. *Id.* A cooperative agreement required tenants to purchase 18 shares of "stock" for every room leased and to pay a small rental charge. *Id.* at 842-43. Originally, the defendants told the plaintiffs that the rental charge was $23.02 per room; however, the charge increased to $39.68 per room. *Id.* at 843. Plaintiffs alleged that the defendants knew that the rental charges would increase and failed to disclose the increase to residents. *Id.* at 844; 844 n.8.

[50] *Id.* at 848. The *Forman* Court stated that there was no clear indication why the parties labeled the instruments "stock." *Id.* at 848 n.13. The Court assumed that the parties used the term "stock" simply as a matter of tradition and convenience. *Id.* The *Forman* Court warned, however, that although the name given to an instrument is not dispositive of finding a security, the name is not wholly irrelevant in deciding whether an instrument is a security. *Id.* at 850. The Court explained that occasions exist when the use of a traditional name such as "stock" or "bonds" might lead a person to justifiably assume that the federal securities laws apply to a transaction, especially when the transaction embodies some of the significant characteristics typically associated with the named instrument. *Id.* at 850-51; *see* Bronstein v. Bronstein, 407 F.Supp. 925, 926-27 (E.D. Pa. 1976) (federal securities laws govern issuance of stock to executive personnel of issuer irrespective of fact that transaction fails *Howey* test because personnel do not rely solely on efforts of others for profit).

[51] 421 U.S. at 851.

[52] *Id.*

transaction to determine if a transaction involves a security.[53] The Court held that profits under the economic realities test require either capital appreciation resulting from the development of an initial investment or a participation in earnings resulting from the use of an investor's funds.[54] The Court also held that the "efforts of others" requirement of the economic realities test requires that an investor receive financial return from the entrepreneurial or managerial efforts of others.[55] Since the purchasers of the stock certificates in *Forman* bought the stock solely to acquire low cost housing and did not expect profits from the entrepreneurial or managerial efforts of others,[56] the Court held that the federal securities laws did not govern the stock certificates.[57]

The *Forman* Court's application of the *Howey* economic realities test demonstrates that the Court prefers a substantive analysis for deter-

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[53] *Id.* at 851. The Supreme Court in *Forman* reversed the Second Circuit's literal approach to the definition of a security. *See* Forman v. Community Servs., 500 F.2d 1246, 1252 (2d Cir. 1974), *rev'd sub nom.* United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975). The Second Circuit held that the mere use of the term "stock" in a financial transaction triggered the protections of the federal securities laws. 500 F.2d at 1252; *see* SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943) (instrument may be a security if it conforms to name or description of a security).

[54] 421 U.S. at 852.

[55] *Id. See* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (earnings resulting from use of investors' funds found in dividends on savings and loan association's profits); SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344, 356 (1943) (capital appreciation resulting from development of initial investment includes sale of oil leases conditioned on promoter's agreement to drill exploratory well).

[56] 421 U.S. at 855-56. The *Forman* Court explained that the tenants could not sell the stock at a profit because when a tenant moved, the Co-op had the option to repurchase the tenant's stock at the original selling price. *Id.* at 842.

[57] *Id.* at 858. Four years after *Forman*, the Supreme Court in International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979), applied the *Howey* economic realities test to an interest in a noncontributory compulsory pension fund. *Id.* at 570. The Teamsters' Union Pension Fund consisted of contributions made by union employers. *Id.* at 552-53. Union members generally could not make individual contributions and could not withdraw from the plan. *Id.* at 553. When an eligible union member retired he received a fixed pension computed according to a standard formula. *Id.* at 561. The *Daniel* Court examined the economic realities of the pension plan and held that the plan was not an investment contract for purposes of the federal securities laws. *Id.* at 570.

The *Daniel* Court held that an employee's participation in a noncontributory compulsory pension plan does not comport with the commonly held understanding of an investment contract. *Id.* at 559. The Court determined that an employee sells his labor primarily to obtain a livelihood, not to make an investment. *Id.* at 560. The Court explained that when an employer's obligation to a pension fund depends on overall man-weeks of labor and not on a particular employee's labor, the employer's contributions to a pension fund do not constitute an investment for a particular employee. *Id.* at 560-61. The Court therefore held that an individual employee does not make an investment of money in a compulsory noncontributory pension plan sufficient to satisfy the *Howey* economic realities test. *Id.* at 561, 570. The Court also held that the pension fund was not a security because even though the fund depended to some extent on earnings from investments made by the fund's trustees, the largest portion of the fund's income came from employer contributions. *Id.* at 561-62. Since an employee's expectation of a pension did not depend on an expectation of profits from the entrepreneurial or managerial efforts of the fund's trustees, the Court held that the pension

mining whether a transaction involves a security.[58] Although most courts follow the Supreme Court's lead and apply a substantive analysis to determine whether a transaction involves a security,[59] many courts continue to ignore the circumstances surrounding a transaction and mechanically apply the literal language in the statutory definition of a security.[60] Recent court decisions concerning the status of promissory notes,[61] loan participations,[62] and the sale of stock in close corporations[63]

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fund did not satisfy the "efforts of others" requirement of the *Howey* test. *Id.*

[58] 421 U.S. at 858. The *Forman* Court stressed that form should be disregarded for substance when defining the meaning and scope of the word security, and the emphasis should be on the economic realities of the transaction. *Id.* at 848 (citing Tcherepnin v. Knight, 389 U.S. 332, 336 (1967)). The Court stated that an item may be within the letter of a statute and yet not within the statute because not within the spirit or intention of the statute. 421 U.S. at 849 (citing Church of the Holy Trinity v. United States, 143 U.S. 457, 459 (1892)); *see* SEC v. National Securities, Inc., 393 U.S. 453, 466 (1969) (legislative policy of federal securities law demands analysis of context of transaction not form of instrument).

After *Forman*, the *Howey* economic realities test defines a security as an investment of money in a common venture on an expectation of either capital appreciation resulting from the development of an investor's initial investment, or a participation in earnings resulting from the entrepreneurial or managerial efforts of others. *See* 421 U.S. at 852. In *International Bhd. of Teamsters v. Daniel*, the Supreme Court held that an employee's labor is not an investment of money sufficient to satisfy the *Howey* test. 439 U.S. at 551, 570. Although the *Daniel* Court implied that a direct transfer of money was not necessary to satisfy the *Howey* test, after *Daniel* serious doubts about the presence of a security must arise when a court cannot find a divisible portion of the consideration attributable to the acquisition of an alleged security. *See* FitzGibbon, *supra* note 3, at 905.

The *Forman* Court did not include the word "solely" in the third prong of the *Howey* test. *See* 421 U.S. at 852. Although the Court stated that the "efforts of others" requirement of the *Howey* test meant "entrepreneurial or managerial efforts," the Court apparently retreated from the "solely" requirement of *Howey*. *See* FitzGibbon, *supra* note 3, at 906. Even before *Forman*, lower courts had held instruments to be securities where the investor assisted in producing profits. *See, e.g.*, SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974) (pyramid marketing scheme where investor's profits partly derived from own efforts is a security); SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir.) (critical inquiry is whether efforts of persons beside investor are the undeniably significant efforts that affect the failure or success of the venture), *cert. denied*, 414 U.S. 821 (1973). *See also* FitzGibbon, *supra* note 3, at 906 (*Forman's* amendment of *Howey* test's "efforts of others" requirement to "largely from the entrepreneurial or managerial efforts of others" opens questions of definition of "largely").

[59] *See* text accompanying notes 69-86, 125-38, 156-72 *infra* (substantive interpretation of definition of a security).

[60] *See* Exchange Nat'l Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1137-38 (2d Cir. 1976) (*Forman* is of dubious value and best course is to follow literal language of statutes); Zabriskie v. Lewis, 507 F.2d 546, 549 (10th Cir. 1974) (literal language of statutory definition of security followed); SEC v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974) (literal approach used); Sanders v. John Nuveen & Co., 463 F.2d 1075, 1079-81 (7th Cir. 1972) (literal definition of security applied); Movielab, Inc. v. Berkey Photo, 452 F.2d 662, 663-64 (2d Cir. 1971) (per curiam) (strict reading of statute).

[61] *See* text accompanying notes 66-104 *infra* (discussion of promissory notes as securities).

[62] *See* text accompanying notes 101-42 *infra* (discussion of loan participations as securities).

[63] *See* text accompanying notes 142-72 *infra* (discussion of stock in close corporations as securities).

exemplify the dichotomy between the literal[64] and substantive[65] interpretations of the definition of a security.

II. PROMISSORY NOTES

The definition of a security in both the '33 Act and the '34 Act provides that unless the context requires otherwise, any "note" or "participation" in any note is a security.[66] Although early decisions held that notes were securities by applying the statutory definitions strictly,[67] application of a substantive analysis led many courts to look beyond the literal language of the statutory definitions.[68] For example, in *Lino v. City Investing Co.*,[69] the Third Circuit recognized that the literal language in the statutory definitions included notes as securities.[70] The court held, however, that notes given in payment to operate a business franchise were not securities under the federal securities laws.[71] The *Lino* court stated that Congress specifically instructed courts, through the language preceding the statutory definitions, that some instruments were within the letter of the statute, but were not within the spirit of the law.[72] The court concluded that the commercial context of the alleged security transaction and the absence of characteristics generally associated with a security, demonstrated that the notes in question were not securities under the federal securities laws.[73]

The *Lino* court determined that promissory notes used in a commercial context were not securities, while promissory notes used in an investment context were securities.[74] The court examined the securities statutes and the statutes' legislative histories and stated that no express reference to consumer or commercial transactions existed.[75] The

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[64] *See* text accompanying notes 87-90, 108-17, 149-55 *infra* (literal approach to definition of a security).

[65] *See* text accompanying notes 41-57 *supra*; text accompanying notes 69-86, 125-38, 156-72 *infra* (substantive approach to definition of a security).

[66] *See* notes 1 & 2 *supra* (statutory definitions of a security in '33 and '34 Acts).

[67] *See, e.g.*, Sanders v. John Nuveen & Co., 463 F.2d 1075, 1083 (7th Cir. 1972); Movielab, Inc. v. Berkey Photo, Inc., 452 F.2d 662, 663 (2d Cir. 1971); *accord*, Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126, 1132 (2d Cir. 1976) (promissory notes presumed not securities).

[68] *See* text accompanying notes 69-86 *infra* (substantive approach applied to promissory notes).

[69] 487 F.2d 689 (3d Cir. 1973).

[70] *Id.* at 691.

[71] *Id.* at 694-95.

[72] *Id.* at 695; *see* Holy Trinity Church v. United States, 143 U.S. 457, 458-59 (1892) (item may be within statute but not within spirit of law). *See also* SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344, 350-51 (1943) (courts should construe details of statute in conformity with statute's dominating purpose).

[73] 487 F.2d at 694-95.

[74] *Id.* at 695.

[75] *Id.*; *see* Note, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L.

court concluded that since the issuer of the notes was a private party and did not offer the notes for sale to the public, did not procure the notes for speculation or investment, and did not use the notes to solicit capital, the entire transaction was commercial in nature and, therefore, the federal securities laws did not govern the transaction.[76]

Other courts have adopted tests similar to the Third Circuit's commercial/investment distinction in analyzing whether promissory notes are securities.[77] In *Great Western Bank & Trust v. Kotz*,[78] the Ninth Circuit held that a corporate note given to a bank in exchange for a renewable line of credit was not a security.[79] The court stated that a note given to a bank in the course of a commercial financing transaction presumably is not a security under the federal securities acts.[80] The court held that a security exists only when a lender subjects "risk capital" to the entrepreneurial or managerial efforts of a borrower.[81]

Although the *Great Western* court did not expressly define risk capital,[82] the court explained that the essential difference between a risk

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REV. 362, 381-83, 397-98 (1972) (legislative history concerning notes as securities is sparse); notes 1 & 2 *supra* (statutory definitions of a security in '33 and '34 Acts).

[76] 487 F.2d at 694-95. Before *Lino*, other federal courts previously had held notes and loans not securities. *See, e.g.*, City Nat'l Bank v. Vanderboom, 290 F.Supp. 592, 608 (W.D. Ark. 1968), *aff'd on other grounds*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); SEC v. Fifth Ave. Coach Lines, Inc., 289 F.Supp. 3, 33 (S.D.N.Y. 1968), *aff'd on other grounds*, 435 F.2d 510 (2d Cir. 1970). The *Lino* court, however, was the first court to directly use the precatory language to the statutory definitions of a security to exclude promissory notes from federal regulation. *See* 487 F.2d at 695. *Lino* apparently made a substantial impact on the commentators' views of promissory notes as securities. *Compare* Lipton & Katz, *"Notes" Are (Are Not?) Always Securities*, 29 BUS. LAW. 861, 863-69 (1974) (promissory notes are securities) *with* Lipton & Katz, *"Notes" Are Not Always Securities*, 30 BUS. LAW. 763, 765-772 (1975) (promissory notes are not securities).

[77] *See, e.g.*, Zabriskie v. Lewis, 507 F.2d 546, 551 (10th Cir. 1974); SEC v. Continental Commodities Corp., 497 F.2d 516, 520 (5th Cir. 1974); McClure v. First Nat'l Bank, 497 F.2d 490, 492 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); Bellah v. First Nat'l Bank, 495 F.2d 1109, 1113 (5th Cir. 1974).

The statutory definition in the '34 Act expressly excludes notes with a maturity of less than nine months. *See* note 2 *supra* (statutory definition of a security in '34 Act); Bellah v. First Nat'l Bank, 495 F.2d at 1114 ('34 Act's nine month maturity exclusion applied to short-term commercial notes). Although the '33 Act does not exempt short-term notes, apparently a note between a private borrower and a single bank would be exempted under the '33 Act's private offerings exemption. *See* 15 U.S.C. § 77(d)(2) (1976) (Securities Act of 1933 private offerings exemption); *accord*, Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126, 1131-33 (2d Cir. 1976) (discussion of short-term commercial paper under '33 and '34 Acts).

[78] 532 F.2d 1252 (9th Cir. 1976).

[79] *Id.* at 1253. The *Great Western* court stated that the plaintiff's case was merely another attempt to convert § 10(b) of the '34 Act into a source of general federal jurisdiction. *Id.*

[80] *Id.* at 1260.

[81] *Id.* at 1257.

[82] *See id.* The *Great Western* court recognized that all loans involve some risk of default. *Id.* at 1259. The court explained, however, that a risky loan involves only a high possibility of default while risk capital involves a direct relationship between a lender's risk

capital contribution and a commercial transaction is the amount of risk involved.[83] The court concluded that the amount of risk involved in a transaction depends upon the length of time the money is on loan, the amount of collateralization, the form of the obligation, the circumstances surrounding the transaction, the relationship between the amount borrowed and the size of the borrower's business, and the contemplated use of the loan proceeds.[84] The court held that the note in question was not risk capital subject to a borrower's managerial efforts because the loan agreement placed extensive restrictions on the borrower's use of loan proceeds and the conduct of the borrower's business operations.[85] Since the notes involved no risk capital, the court concluded that the notes were not securities.[86]

Three months after *Great Western*, the Second Circuit criticized the commercial/investment distinction and risk capital analysis of promissory notes in *Exchange National Bank v. Touche Ross & Co.*[87] The Second Circuit reasoned that a presumption that promissory notes are securities more closely adheres to the language of the statutory definitions than does the *Great Western* presumption that promissory notes are not securities.[88] The *Exchange National* court, therefore, applied the literal language of the statutory definitions and held that the federal securities laws governed promissory notes that were part of a large financing operation conducted by a brokerage firm.[89] The court recognized in dictum, however, limited situations when a promissory note may not be a security.[90]

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of default and a borrower's managerial efforts. *Id.* at 1259-60. *See also* United Cal. Bank v. THC Fin. Corp., 557 F.2d 1351, 1358 (9th Cir. 1977) (notes evidencing risk of nonpayment are securities while notes evidencing risky loans are not securities).

[83] 532 F.2d at 1257.

[84] *Id.* at 1257-58.

[85] *Id.* at 1259-60. The *Great Western* court concluded that the note was a commercial transaction subject to the risks normally associated with commercial loans. *Id.*

[86] *Id.* at 1260.

[87] 544 F.2d 1126 (2d Cir. 1976).

[88] *Id.* at 1138. The *Exchange National* court stated that efforts to define a security under the commercial/investment distinction carry little promise of success. *Id.* at 1136. The court criticized the *Howey* economic realities test because the test seems of "dubious value" when applied to promissory notes. *Id.*; *see* text accompanying notes 41-46 *supra* (*Howey* economic realities test).

[89] 544 F.2d at 1138. Since the notes in *Exchange National* were part of a large financing operation conducted by a brokerage firm and both parties knew that the state stock exchange would consider the proceeds of the notes equivalent to equity capital, the notes would probably have been securities even under a commercial/investment or risk capital approach. *See id.* at 1128-29; McClure v. First Nat'l Bank, 497 F.2d 490, 493-94 (5th Cir. 1974) (investment notes indicated if notes offered to class of investors, acquired for speculation, or acquired as investment assets), *cert. denied*, 420 U.S. 930 (1975); text accompanying notes 69-86 *supra* (discussion of commercial/investment test and risk capital test).

[90] 544 F.2d at 1138-39. The *Exchange National* court stated that consumer financing notes, mortgage notes on a home, short-term notes secured by a lien on a small business or its assets, notes evidencing "character" loans to a bank customer, short-term notes secured

Although dictum, the *Exchange National* court's recognition that some promissory notes are not securities demonstrates that even in the Second Circuit, the last stronghold of the literal approach,[91] courts recognize that promissory notes are not always securities.[92] Courts after *Exchange National*, however, have not adopted the Second Circuit's presumption that promissory notes are securities.[93] Instead, courts have examined the circumstances surrounding a transaction involving a promissory note to determine if a security exists.[94] For example, in *Baurer v. Planning Group, Inc.*,[95] the District of Columbia Circuit refused to apply a literal analysis to promissory notes and examined the circumstances surrounding the notes in question to determine if the securities acts governed the transaction.[96]

In *Baurer*, the plaintiff delivered a check to the defendants for $15,000.[97] In exchange for the check, the defendants issued a promissory note to the plaintiff for the same amount.[98] The note expressly stated that plaintiff's loan was in lieu of a capital contribution to a limited partnership being organized by the defendants.[99] The *Baurer* court held that the securities laws govern only investment transactions and applied the *Howey* economic realities test to the defendants' promissory note to determine if the note was commercial or investment in nature.[100]

The *Baurer* court determined that the parties intended the note to

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by an assignment of accounts receivables, and notes formalizing an open-account debt incurred in the ordinary course of business usually are not securities. *Id.* When a note does not bear a strong "family resemblance" to these examples, the court held that the federal securities laws applied. *Id.*; *see* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 850-51 (1975) (name given instrument might lead person justifiably to assume federal securities laws apply to transaction); note 58 *supra* (discussion of *Forman* Court's analysis of label given to instrument).

[91] *See* Union Planters Nat'l Bank v. Commercial Credit, 651 F.2d 1174, 1180 n.7 (6th Cir. 1981) (literalism discredited everywhere except for "new literalism" of Second Circuit).

[92] *See, e.g.*, Williamson v. Tucker, 645 F.2d 404, 426 (5th Cir.), *cert. denied*, 102 S. Ct. 396 (1981); Baurer v. Planning Group, [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,365 (D.C. Cir. 1981); Amfac Manuf. Corp. v. Arizona Mall of Tempe, Inc., 583 F.2d 426, 433 (9th Cir. 1978); American Bank & Trust Co. v. Wallace, 529 F.Supp. 258, 261 (E.D. Ky. 1981).

[93] *See* note 92 *supra* (substantive analysis applied in recent decisions concerning promissory notes).

[94] *See, e.g.*, Williamson v. Tucker, 645 F.2d 404, 426 (5th Cir.), *cert. denied*, 102 S. Ct. 396 (1981); Baurer v. Planning Group, [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,365 (D.C. Cir. 1981); Amfac Manuf. Corp. v. Arizona Mall of Tempe, Inc., 583 F.2d 426, 433 (9th Cir. 1978); Great W. Bank & Trust Co. v. Kotz, 532 F.2d 1252, 1258-60 (9th Cir. 1976); C.N.S. Enter. v. G. & G. Enter., 508 F.2d 1354, 1361-63 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); Zeller v. Bogue Elec. Manuf. Corp., 476 F.2d 795, 800 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973).

[95] [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,362 (D.C. Cir. 1981).

[96] *Id.* at 92, 231-32.

[97] *Id.* at 92, 227-29.

[98] *Id.*

[99] *Id.*

[100] *Id.* at 92, 229-32.

be an investment.[101] The court held that the language of the note demonstrated that the defendants induced the plaintiff to advance money by a promise of an investment opportunity.[102] The plaintiff advanced money in reliance on the defendants' representations of their entrepreneurial and managerial skills for successfully forming and operating a profitable partnership.[103] Since the note in question represented an investment in a common venture premised on an expectation of profits derived from the entrepreneurial or managerial efforts of another, the *Baurer* court held that the note was a security governed by the securities acts.[104]

III. LOAN PARTICIPATIONS

Baurer and other decisions examining whether promissory notes are securities provide guidance for courts determining whether loan participations are securities because promissory notes form an integral part of loan participations.[105] A loan participation is a transaction in which a lead bank or similar financial institution sells to one or more participating banks or financial institutions an undivided, fractional interest in a promissory note and any collateral securing the note.[106] Similar to courts examining whether promissory notes are securities, courts examining whether loan participations are securities apply both literal and substantive approaches.[107] For example, the Fifth Circuit in *Lehigh*

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[101] *Id.* at 92, 232.

[102] *Id.*

[103] *Id.*

[104] *Id.* Although the *Baurer* court did not expressly determine that the proposed partnership was a common venture under the *Howey* economic realities test, the court determined that the parties were jointly responsible for the partnership's success and therefore, the partnership clearly was a common venture. *See id.*

[105] *See Bank Loan, supra* note 18, at 262-65.

[106] *See id.* at 262-64 (explanation of loan participation). Although a loan participation does not have to involve a financial institution, an overwhelming majority of participations involve banks and finance companies. *See id.*

In a typical loan participation, the participating bank often has no direct legal or personal relationship with the borrower. *See id.* at 262-63, 262 n.11. The lead bank issues a participation agreement that regulates the participating bank's rights to payments of principal and interest and to any loan collateral. *See id.* at 263. A loan participation therefore is distinguishable from a multi-bank or syndicate loan in which each bank loans money directly to a borrower and an agent bank merely administers or moderates the loan. *Id.* at 263 n.12. Participations allow a bank to fulfill the needs of a client when a bank could not otherwise do so because of either insufficient reserves or lending ceilings. *See id.* at 263-65; Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989, 991 (5th Cir. 1969) (state law precluded lead bank from extending more credit to customer). Participations also help spread the risk associated with a loan because just as the lead bank and the participants receive a pro rata share of interest and principal repayments, they also share pro rata in any loss if default occurs. *See Bank Loan, supra* note 18, at 265.

[107] *See* note 138 *infra* (cases using literal and substantive approaches).

Valley Trust Co. v. Central National Bank[108] applied a literal analysis to determine if a loan participation was a security under the federal securities laws.[109] In *Lehigh Valley*, Central National Bank offered a portion of a loan for participation to Lehigh Valley Trust Company.[110] After the loan was in default, Lehigh Valley filed a rule 10b-5 action alleging that Central failed to disclose that the loan was a significant risk.[111]

The *Lehigh Valley* court examined the statutory definition of a security and determined that the participation was a security under federal law.[112] The court noted that the statutory definition included any "note" and that the Supreme Court has construed the antifraud provisions of the federal securities laws expansively.[113] The court also noted that the statutory definition of a security included any certificate of interest or participation in a note.[114] The *Lehigh Valley* court concluded that it must read the statute literally[115] and, therefore, held that the participation was a certificate of interest on a note covered by the federal securities laws.[116]

Although commentators criticized *Lehigh Valley* for not examining the language preceding the statutory definitions[117] and for not examining the exemptions of certain notes in the statutory definitions,[118] the decision demonstrates that a loan participation can be a security under the federal securities laws, especially when the note underlying the participation is a security.[119] Determining that a note involved in a loan par-

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[108] 409 F.2d 989 (5th Cir. 1969).

[109] *Id.* at 991.

[110] *Id.*

[111] *Id.* at 991-92. The loan in *Lehigh Valley* was a significant risk because the corporation whose stock collateralized the loan had filed for reorganization under the Bankruptcy Act. *Id.* at 990-91. Lehigh Valley was not told about the reorganization petition and also was not told that a prime guarantor of the loan was already in default to Central National on personal obligations, that other banks were already foreclosing on collateral for other loans, and that bank examiners had criticized other loans made to the borrowers. *Id.*

[112] *Id.* at 992.

[113] *Id.* at 992-93; *see* notes 1 & 2 *supra* (statutory definitions of a security). Apparently the *Lehigh Valley* court followed the policy of broadly construing the remedies of the federal securities laws in order to deter fraud in the market. *See* SEC v. National Sec., Inc., 393 U.S. 453, 455 (1969); Tcherepnin v. Knight, 389 U.S. 332, 338 (1967).

[114] 409 F.2d at 993.

[115] *Id.*; *see* note 113 *supra.*

[116] *Id.* at 995.

[117] *See* Epstein, *Bank Participation Agreements as Securities*, 87 BANKING L.J. 99, 102-03 (1970) [hereinafter cited as Epstein] (*Lehigh Valley* court should have considered precatory language to statutory definition); *Bank Loan, supra* note 18, at 271 n.54.

[118] *See* 15 U.S.C. § 78c(a)(10) (1976) ('34 Act's statutory definition excludes any note that has a maturity at time of issuance of less than nine months); 15 U.S.C. § 77c(a)(3) (1976) (similar exemption found in '33 Act); notes 1 & 2 *supra* (statutory definitions of a security).

[119] *See, e.g.*, Avenue State Bank v. Tourlet, 379 F. Supp. 250, 254 (N.D. Ill. 1974) (dictum); Crowell v. Pittsburgh & L.E.R.R. Co., 373 F.Supp. 1303, 1307 (E.D. Pa. 1974). *See generally* Epstein, *supra* note 117.

ticipation is not a security, however, does not determine necessarily that a loan participation itself is not a security. If a court decides that a loan participation itself is an investment contract, the status of notes underlying the participation becomes irrelevant because an investment contract is a security under both the '33 and '34 Acts.[120] Courts examining participations as investment contracts, however, rely heavily on the type of loan underlying the participation.[121] Many courts thus apply a type of hybrid analysis consisting of a combination of the *Howey* economic realities test[122] and the risk capital or commercial/investment analysis[123] to examine loan participations alleged to be securities.[124]

In *Union Planters National Bank v. Commercial Credit*,[125] the Sixth Circuit applied a combination of the *Howey* economic realities test and the risk capital test to determine if a loan participation agreement was a security under the '34 Act.[126] The *Union Planters* court applied a risk capital analysis to determine if the participation satisfied the "investment of money" requirement of the *Howey* economic realities test.[127] Although the court recognized that in one sense, every lender of money is an investor because he places his money at risk in anticipation of profit in the form of interest,[128] the court rejected this analysis and held that the participation was not an investment under the *Howey* test.[129] Since repayment of the underlying loan began almost immediately and the borrower's accounts receivable collateralized the loan, the court concluded that under the *Great Western* risk capital analysis,[130] the loan merely was a commercial transaction and not an investment.[131]

The *Union Planters Bank* court also concluded that the participation failed the "expectation of profits" and the "efforts of others" requirements of the *Howey* test.[132] The court held that periodic interest payments received under the participation agreement were not capital

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[120] *See* notes 1 & 2 *supra* (statutory definitions of a security); *Bank Loan*, *supra* note 18, at 281-86 (discussion of loan participations as investment contracts).

[121] *See, e.g.*, Robbins v. First Am. Bank of Va., [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,240 (N.D. Ill. 1981); Union Planters Nat'l Bank v. Commercial Credit, 651 F.2d 1174, 1185 (6th Cir. 1981).

[122] *See* text accompanying notes 41-57 *supra* (discussion of the *Howey* economic realities test).

[123] *See* text accompanying notes 69-86 *supra* (discussion of the commercial/investment and risk capital tests).

[124] *See* notes 125-38, *infra* (cases using hybrid test for a security).

[125] 651 F.2d 1174 (1981).

[126] *Id.* at 1180-85.

[127] *Id.* at 1181-83.

[128] *Id.* at 1181.

[129] *Id.* at 1181-83.

[130] 532 F.2d 1252, 1257 (9th Cir. 1976). *See* text accompanying notes 78-86 *supra* (discussion of risk capital analysis).

[131] 651 F.2d at 1181-82.

[132] *Id.* at 1184-85.

appreciation resulting from an initial investment, or a participation in earnings, and therefore not profits.[133] Since the interest payments were not profits, Union Planters Bank could not have an expectation of receiving profits.[134] Although the court recognized that Commercial Credit supervised the repayment of the loan,[135] the court concluded that Commercial Credit's efforts were not managerial or entrepreneurial as required by the *Howey* test.[136] Commercial Credit's responsibilities were merely routine loan monitoring tasks that generated no expectation of profits.[137] Since the participation failed the "investment of money," the "expectation of profits," and the "efforts of others" requirements of the *Howey* test, the Sixth Circuit affirmed the district court's ruling that the loan participation agreement did not constitute a security.[138]

A majority of courts faced with whether a loan participation is a security have abandoned a literal, mechanical approach in favor of a hybrid analysis similar to the one applied in *Union Planters Bank*.[139] Although some courts continue to apply a literal approach to loan participations and other types of instruments,[140] most courts have adopted a substantive analysis for examining all types of alleged securities transactions.[141] The literal approach, however, still plays an important part in

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[133] *Id.* at 1184; *see* text accompanying notes 41-46 *supra* (*Howey* definition of profits).

[134] 651 F.2d at 1184-85.

[135] *Id.* at 1185.

[136] *Id.*

[137] *Id.* The *Union Planters* court distinguished the efforts of a borrower who worked to repay a loan from the efforts of Commercial Credit who performed administrative tasks connected with a loan. *Id.* Since Commercial Credit's administrative tasks were not similar to a borrower's efforts to repay a loan, the court concluded that the participation failed the efforts of others requirement of the *Howey* test. *Id.*

[138] *Id.* The majority of courts to consider whether loan participations are securities have held that the federal securities laws do not govern participations or interests in loans or notes. *See, e.g.*, Robbins v. First Am. Bank of Va., [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,240 (N.D. Ill. 1981); American Fletcher Mortgage v. U.S. Steel, 635 F.2d 1247, 1253-54 (7th Cir. 1980), *cert. denied*, 101 S. Ct. 1982 (1981); United Bank of Nashville v. Gunter, 620 F.2d 1108, 1110 (5th Cir. 1980); Manchester Bank v. Conn. Bank & Trust Co., 497 F.Supp. 1304, 1309-13 (D. N.H. 1980); Provident Nat'l Bank v. Frankfort Trust Co., 468 F.Supp. 448, 452-55 (E.D. Pa. 1979); FBS Fin., Inc. v. Clevetrust Realty Investors, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,341 (N.D. Ohio 1977).

A minority of courts considering whether a loan participation is a security have concluded that participations are securities. *See, e.g.*, Commercial Discount Corp. v. Lincoln First Commercial Corp., 445 F. Supp. 1263, 1271 (S.D.N.Y. 1978); NBI Mort. Corp. v. Chemical Bank [1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,632 (S.D.N.Y. 1976) and [1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,066 (S.D.N.Y. 1977).

[139] *See* note 138 *supra* (majority of courts do not consider loan participations to be securities).

[140] *See* note 138 *supra* (minority of courts apply literal approach to loan participations).

[141] *See* note 138 *supra* (majority of courts apply substantive analysis to loan participations); note 94 *supra* (substantive analysis applied to promissory note); note 170 *infra* (substantive analysis applied to sale of stock in close corporation).

examining whether the sale of 100 percent of a business' corporate stock is a securities transaction under the '33 and '34 Acts.[142]

IV. STOCK IN CLOSE CORPORATIONS

Both the '33 and '34 Acts include the term "stock" in the statutory definition of a security.[143] Unlike the stock certificates in *United Housing Foundation, Inc. v. Forman*,[144] the stock in a normal close corporation possesses all the traditional attributes of stock.[145] Most corporate stock is fully negotiable, possesses the right to vote, the right to receive dividends, and the potential to appreciate in value.[146] The sale of 100 percent of the stock in a close corporation, therefore, apparently constitutes a sale of a security under the federal securities laws.[147] A detailed examination of the sale of a business, however, reveals that the transaction predominantly is commercial in nature.[148] The question then arises whether a court should literally apply the statutory definitions or apply the economic realities test to determine if the federal securities laws govern the sale of an entire business.

In *Mifflin Energy Sources, Inc. v. Brooks*,[149] the District Court for the Western District of Pennsylvania held that the federal securities laws governed the sale of 100 percent of a small strip mining company's stock.[150] The defendant argued that the economic realities test applied in *Forman* demonstrated that the transaction actually was a sale of an ongoing business and not a sale of a security.[151] The *Mifflin* court, however, interpreted *Forman* as requiring an economic realities analysis only when the instrument in question was a "stock purchase agreement" and did not possess the traditional attributes of stock.[152] The *Mifflin* court ex-

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[142] *See* text accompanying notes 143-72 *infra* (sale of stock in close corporation under federal securities law).

[143] *See* notes 1 & 2 *supra* (statutory definitions of a security).

[144] 421 U.S. 837 (1975); *see* text accompanying notes 47-58 *supra* (discussion of *Forman*).

[145] *See* text accompanying note 146 *infra*.

[146] *See, e.g.*, Golden v. Garafalo, 521 F.Supp. 350, 353-55 (S.D.N.Y. 1981); Mifflin Energy Sources, Inc. v. Brooks, 501 F.Supp. 334, 335-37 (W.D. Pa. 1980).

[147] *See* notes 1 & 2 *supra* (statutory definitions of a security). *See also* Coffin v. Polishing Mach., Inc., 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 100 S. Ct. 142 (1979) (sale of stock in close corporation governed by securities acts); Titsch Printing, Inc. v. Hastings, 456 F.Supp. 445, 447-49 (D. Colo. 1978) (sale of stock in close corporation is securities transaction); Bronstein v. Bronstein, 407 F.Supp. 925, 930 (E.D. Pa. 1976) (sale of stock in family corporation is a security).

[148] *See* text accompanying notes 156-72 *infra* (sale of stock in close corporation does not have attributes of securities transaction). *Compare* Mifflin Energy Sources, Inc. v. Brooks, 501 F.Supp. 334, 335-37 (W.D. Pa. 1980) (sale of stock is automatically a securities transaction) *with* Golden v. Garafalo, 521 F.Supp. 350, 353-55 (S.D.N.Y. 1981) (sale of stock requires application of economic realities test).

[149] 501 F.Supp. 334 (W.D. Pa. 1980).

[150] *Id.* at 335.

[151] *Id.* at 335-36; *see* text accompanying notes 47-58 *supra* (discussion of *Forman*).

[152] 501 F.Supp. at 335.

amined the shares of stock and determined that they possessed the traditional attributes of stock.[153] The court determined that because the sale of the business involved instruments commonly known as stock and the statutory definition of a security included stock, the federal securities laws applied to the sale transaction and the sale automatically triggered the antifraud provisions of the '33 and '34 Acts.[154] The court explained that the fact that the transaction resulted in the sale of a business was immaterial to the question of whether the stock was a security.[155]

Although the *Mifflin* court refused to apply the economic realities test to the sale of corporate stock, in *Anchor-Darling Industries, Inc. v. Suozzo*,[156] the District Court for the Eastern District of Pennsylvania adopted a broader reading of *Forman* and applied the economic realities test to a sale of stock in three closely held corporations.[157] The court did not inquire whether the shares of stock in question possessed the traditional attributes of stock.[158] Instead, the court examined the circumstances surrounding the stock sale to determine whether the transaction involved a security.[159] In the transaction, Anchor-Darling Industries bought Suozzo's controlling interest in three closely held corporations.[160] The sale divested Suozzo of all ownership and of all positions in the companies.[161] Suozzo did, however, enter into consulting agreements with the three corporations.[162] After the sale, Anchor-Darling filed a rule 10b-5 action alleging Suozzo made several knowing misrepresentations in the stock purchase agreement.[163]

The *Anchor-Darling* court interpreted *Forman* as requiring an application of the economic realities test every time an allegation of a sale of a security is at issue.[164] The court applied the economic realities test

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[153] *Id.* at 335-36.

[154] *Id.* at 336.

[155] *Id.* The *Mifflin* court found that the actual sale of the stock was the substance of the transaction and was not meant to represent a symbolic transfer of an indicia of ownership. *Id.*

Many benefits accrue to parties who transfer ownership in a business by transferring stock instead of selling a business' assets. *See* Comment, *The Sale of a Close Corporation Through A Stock Transfer: Covered by the Federal Securities Laws?* 11 SETON HALL L. REV. 749, 762, 763 n.100 (1981) (tax benefits and avoidance of federal securities laws). The biggest advantage to selling stock instead of a corporation's assets is avoiding compliance with state "bulk sale" laws. *See* U.C.C. Art. 6 (1981) (registration and notice to creditors required with bulk sales).

[156] 510 F.Supp. 659 (E.D. Pa. 1981).

[157] *Id.* at 662-66.

[158] *See id.* at 663.

[159] *Id.* at 662-66.

[160] *Id.* at 661.

[161] *Id.*

[162] *Id.*

[163] *Id.* at 661-62.

[164] *Id.* at 662-63.

and held that the transaction did not involve a security because there was not an investment in a common enterprise with an expectation of profits to be derived from the efforts of another.[165] The court concluded that because Anchor-Darling in no way shared or pooled funds from the companies with Suozzo, no common venture existed that would satisfy the economic realities test.[166] Since Anchor-Darling was solely responsible for the continued management of the companies and relied on no one else to bring about the profits from the companies,[167] the court concluded that the transaction did not satisfy the "profits derived from the efforts of others" requirement of the *Howey* economic realities test.[168]

The results in *Mifflin* are typical of cases applying a literal analysis to whether the sale of an entire business is a security.[169] The analysis applied in *Anchor-Darling*, however, exemplifies the analysis employed by most courts to determine the status of a sale of an entire business under the federal securities laws.[170] Although language in the Supreme Court's *Forman* opinion lends some support to the literal approach,[171] an examination of the entire *Forman* decision in light of other Supreme Court opinions concerning the definition of a security reveals that the Supreme Court overwhelmingly prefers using a substantive analysis to examine alleged securities transactions.[172]

A substantive analysis of all alleged securities transactions promotes the congressional intent behind the federal securities laws. The congressional purpose of the securities acts is to provide the investing public with broad, easily obtained remedies for unscrupulous practices in the securities market.[173] Congress, however, intended the broad remedies of the securities acts to apply only to transactions that involve a security.[174] A substantive analysis of the definition of a security,

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[165] *Id.* at 666.

[166] *Id.*

[167] *Id.*

[168] *Id.*

[169] *See, e.g.*, Coffin v. Polishing Mach., Inc., 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 100 S. Ct. 142 (1979); Titsch Printing, Inc. v. Hastings, 456 F.Supp. 445, 447-49 (D. Colo. 1978); Bronstein v. Bronstein, 407 F.Supp. 925, 929 (E.D. Pa. 1976).

[170] *See, e.g.*, Reprosystem, B.V. v. SCM Corp., [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,207 (S.D.N.Y. 1981); Frederiksen v. Poloway, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,815 (7th Cir. 1981); Chandler v. Kew, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,966 (10th Cir. 1977); Golden v. Garafalo, 521 F.Supp. 350, 358 (S.D.N.Y. 1981); Smogyi v. Butler, 518 F.Supp. 970, 987 (D.N.J. 1981); Dueker v. Turner, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,386 (N.D. Ga. 1979); Bula v. Mansfield, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,964 (D. Colo. 1977); Tech Resources, Inc. v. Estate of Hubbard, 246 Ga. 583, 585-86, 272 S.E.2d 314, 316-17 (1980) (applying federal law).

[171] *See* note 50 *supra* (discussion of *Forman's* support for literal approach).

[172] *See* text accompanying notes 47-58 *supra* (*Forman* Court supports substantive approach); note 41 *supra* (Supreme Court decisions supporting substantive approach).

[173] *See* note 22 *supra* (congressional intent of securities laws).

[174] *See* Marine Bank v. Weaver, _____ U.S. _____, _____, 50 U.S.L.W. 4285, 4287

whether the analysis includes the commercial/investment distinction,[175] the risk capital test,[176] the economic realities test,[177] or a combination of tests,[178] prevents turning the policy of broad, easily obtained remedies under the federal securities laws[179] into a broad, expansive definition of a security. The substantive approach allows only parties in transactions with characteristics of securities transactions to obtain the broad remedies of the securities acts.[180] The literal approach, however, permits the securities acts to govern any transaction that includes an instrument listed in the statutory definitions, regardless of whether the instrument has the characteristics of a security.[181] The flexible standards of a substantive approach protect the public from the countless and variable schemes devised by persons seeking the use of other persons' money on the promise of profits,[182] and also avoids turning the securities laws into a remedy for unhappy businessmen prevented from recovering damages under state law.[183]

Courts should consider the instruments listed in the statutory definition of a security merely as examples of instruments that can be securities.[184] The presence of an instrument listed in the statutory definition should alert a court that the instrument could be a security. Once alerted, a court then can apply a substantive analysis to determine if the federal securities laws govern the transaction. If the statutory definition

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(March 9, 1982) (Congress intended securities laws to cover instruments commonly considered securities); Woodward v. Metro Bank of Dallas, 522 F.2d 84, 91 (5th Cir. 1975) (transaction must involve a security before '34 Act applies); Woodward v. Wright, 266 F.2d 108, 122 (10th Cir. 1959) (securities laws not intended to apply to all transactions); note 22 *supra* (congressional intent of securities laws).

[175] *See* text accompanying notes 69-77 *supra* (commercial/investment dichotomy).

[176] *See* text accompanying notes 78-86 *supra* (risk capital test).

[177] *See* text accompanying notes 41-58 *supra* (economic realities test).

[178] *See* text accompanying notes 125-38 *supra* (hybrid analysis applied to loan participations).

[179] *See* notes 18-27 *supra* (policy and broad remedies of '33 and '34 Acts).

[180] *See* SEC v. W. J. Howey Co., 328 U.S. 293, 298-99 (1946) (land sales and service contracts with characteristics of securities governed by federal securities laws); note 17 *supra* (instruments without characteristics of securities not governed by securities statutes).

[181] *See* Forman v. Community Servs., Inc., 500 F.2d 1246, 1252 (2d Cir. 1974) (stock certificates without traditional attributes of stock are securities), *rev'd sub nom.* United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975); text accompanying notes 67, 87-91, 108-16, 149-55 *supra* (literal approach to definition of a security).

[182] *See* Marine Bank v. Weaver, _____ U.S. _____, _____, 50 U.S.L.W. 4285, 4286 (March 9, 1982) (quoting SEC v. W. J. Howey Co., 328 U.S. 293, 299 (1946)).

[183] *See* Union Planters Nat'l Bank v. Commercial Credit, 651 F.2d 1174, 1175 (6th Cir. 1981) (securities laws do not provide an easy remedy for plaintiffs prevented from recovery in state law claims); note 21 *supra* (securities laws are not panacea for commercial transactions gone awry).

[184] *See* Marine Bank v. Weaver, _____ U.S. _____, _____, 50 U.S.L.W. 4285, 4286 (March 9, 1982) (although "certificates of deposit" listed in statutory definition, label given instrument is not controlling); United Hous. Found., Inc. v. Forman, 421 U.S. 842, 848-52 (1975) (instrument labeled "stock" puts courts on notice that a security may exist).

does not list an alleged security, a court can apply the economic realities test to determine if the instrument is an investment contract.[185] Although courts outside the Second Circuit apparently apply a substantive analysis to all alleged securities transactions,[186] if the Second Circuit's literal approach to the definition of a security gains widespread popularity, the day will come when not a sparrow falls without the securities laws nodding their assent.[187]

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[185] *See* SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946) (economic realities test applied to sales and service contracts); text accompanying notes 35-57 *supra* (discussion of investment contracts and economic realities test).

[186] *See* text accompanying notes 41-57, 69-86, 125-38, 156-72 *supra* (substantive approach to definition of a security); note 17 *supra* (cases applying substantive approach to alleged securities transactions).

[187] *See* Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367, 368 n.9 (1967); *Matthew* 10:29.