

Bank Loans as Securities (Exchange National Bank v. Touche Ross & Co.)

Alfred Groner

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tenants would receive profit from capital appreciation.⁵¹

In *Grenader v. Spitz*, the Second Circuit achieved a uniformity in its decisions regarding the applicability of the federal securities laws to cooperative apartment shares. It is highly questionable, however, whether an all-inclusive exclusion of such shares is warranted. Neither the congressional intent behind the Acts nor the Supreme Court decision in *Forman* mandated such a result. Indeed, the Supreme Court in *Howey* stated that the legislative history of the Acts indicates that the definition of an investment contract must be interpreted to adapt "to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."⁵² Additionally, the Court's emphasis on substance over form suggests that in some cooperative housing situations the economic realities underlying the transaction will require the protection of the federal securities laws. It is submitted that in *Grenader* the transaction fell within the definition of an investment contract, and thus the investors should have been afforded the protection of the federal securities laws.⁵³

Douglas Morea

BANK LOANS AS SECURITIES

Exchange National Bank v. Touche Ross & Co.

Plaintiffs who have incurred financial losses in business transactions often attempt to gain redress in the federal courts through the antifraud provisions of the Securities Act of 1933¹ and the Securities Exchange Act of 1934.² Where the allegedly fraudulent transac-

⁵¹ See notes 44-45 and accompanying text *supra*.

⁵² 328 U.S. at 299, *citing* H.R. REP. NO. 85, 73d Cong., 1st Sess. 11 (1933).

⁵³ Without the protection of the federal securities laws, cooperative apartment shareholders are shielded from abuse only by state laws which many commentators consider inadequate. A majority of the states have either refused to pass laws designed to curb abuses of cooperative apartment housing or have simply extended their securities laws, many of which have been interpreted restrictively. See *Cooperative Housing*, *supra* note 32, at 122. One authority, commenting upon the inadequacy of state securities laws, has stated, "[t]hese statutes, however, seem to have failed in curbing most abuses, primarily because of inadequate regulations and incomplete statutory summaries in their required prospectuses." *Id.* (footnote omitted); *cf.* Miller, *supra* note 32, at 486-89 (New York regulatory scheme inadequate).

¹ Securities Act of 1933, § 17(a), 15 U.S.C. § 77q(a) (1970).

² Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78j(b) (1970); 17 C.F.R. § 240.10b-5 (1976).

tion sought to be remedied includes an instrument, courts frequently grapple with the threshold jurisdictional question whether the particular instrument involved is a security.³ In *Exchange National Bank v. Touche Ross & Co.*,⁴ the Second Circuit was faced with the issue whether promissory notes ranging in maturity from one year to eighteen months were securities within the definitional sections of the 1934 Act. Invoking the statutory language, which defines a note with a maturity greater than nine months to be a security "unless the context otherwise requires,"⁵ and concluding that there was not a sufficient showing that the context of the transaction required a contrary finding, the court held the notes in issue to be securities within the ambit of the 1934 Act.⁶

The transactions challenged in *Touche Ross* began in March 1972, when Weis, Voisin & Co. (Weis), a now defunct stock brokerage firm, approached Exchange National Bank to secure a loan in return for three promissory notes.⁷ Prior to accepting the notes, the

³ See generally Long, *Definition of a Security*, 6 ST. MARY'S L.J. 96 (1974); Pollock, *Notes Issued in Syndicated Loans—A New Test to Define Securities*, 32 BUS. LAW. 537 (1977); Selvers, *Investment Contracts: Expanding Effective Securities Regulation*, 48 ST. JOHN'S L. REV. 525 (1974).

⁴ 544 F.2d 1126 (2d Cir. 1976), *aff'g* No. 75-0916 (S.D.N.Y. Oct. 3, 1975).

⁵ The definitional section of the Securities Exchange Act of 1934 states in pertinent part: When used in this chapter, unless the context otherwise requires —

. . . .
(10) The term "security" means any note, stock, treasury stock, bond, debenture, . . . investment contract, . . . or, in general, any instrument commonly known as a "security"; or any certificate of interest or participation in . . . 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. . . .

Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1970). The definitional provision of the Securities Act of 1933, § 2(a), 15 U.S.C. § 77(b)(1) (1970), does not include the nine-month limitation, but is otherwise virtually identical with that of the 1934 Act.

⁶ 544 F.2d at 1138-39. The court asserted that the most appropriate approach to the definitional problem concerning promissory notes "may lie in greater recourse to the statutory language." *Id.* at 1137. Accordingly, the Second Circuit stated that when a note falls within the literal definition of the Securities Act or the Exchange Act, the litigant who contends that it is not a security must prove that the context of the transaction takes the note outside the realm of the securities acts. Noting, however, that it is not clear whether § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1970), provides a private civil remedy, 544 F.2d at 1137 n.18, and that the notes involved in the instant case had a maturity date longer than nine months and thus were within the definitional section of the 1934 Act, the court primarily based its decision on the 1934 Act. In so doing, Judge Friendly "left for another day" the question whether a note with a maturity date of less than nine months could be a security under the antifraud provisions of the Exchange Act. *Id.* at 1138 n.19.

⁷ The three notes were payable in 12, 15, and 18 months, upon 6 months' advance written notice by the bank. They were subordinated to the claims of Weis' general creditors and were executed in a form provided by Weis and approved by the New York Stock Exchange. The

bank requested that Weis supply certified financial statements. Touche Ross & Co., a well-known accounting firm, certified the statements for Weis. They were forwarded to Exchange National, and in July 1972, the bank agreed to the loan. In May 1975, Weis was placed in receivership and its notes became worthless. Alleging that the financial statements were materially false and misleading and that Touche Ross knew or should have known this, the bank then instituted an action in federal district court against Touche Ross for violations of the antifraud provisions of the securities acts.⁸ Moving to dismiss the complaint for lack of subject matter jurisdiction, Touche Ross maintained that the notes in question evinced an ordinary commercial loan and therefore were not securities.⁹ The district court denied the motion, characterizing the transaction as more in the nature of an investment than a commercial loan. Finding the question to be a "close one," however, the court certified the issue for appellate review.¹⁰

After first disposing of a procedural challenge to the district court's denial of the defendant's motion to dismiss,¹¹ Judge Friendly, writing for a unanimous panel,¹² turned to the definitional question. Noting that the federal courts are in disagreement as to whether the antifraud provisions of the 1933 Act provide a civil remedy,¹³ the court concentrated on the 1934 Act, particularly considering the explicit language in that Act which includes in the

notes were senior to or *pari passu* with the claims of other subordinated lenders. 544 F.2d at 1128. They bore interest at 3% over the Exchange Bank's prime commercial rate, with a minimum rate of 9% per annum. Prepayment and transferability were restricted and were subject to approval by the New York Stock Exchange. *Id.* at 1129. The bank waived the right of setoff, and the "right to take as security any property of [Weis] that might come into its possession." *Id.*

⁸ *Id.* at 1128.

⁹ *Id.*

¹⁰ *See id.* at 1130.

¹¹ The Second Circuit was initially confronted with the defendant's contention that the district court improperly denied its motion to dismiss for lack of subject matter jurisdiction under rule 12(b)(1) of the Federal Rules of Civil Procedure. Declaring that the district court's decision was based on material in the plaintiff's affidavits, Touche Ross asserted that a 12(b)(1) motion does not permit the courts to consider information from sources other than the pleadings. *Id.* at 1130. In ruling on this argument, Judge Friendly first noted that the general rule prior to amendment of rule 12(b) was that motions challenging jurisdiction could be decided on the basis of affidavits as well as pleadings. Concluding that the amendment did not change the traditional rule, the Second Circuit upheld the lower court's decision. *Id.* at 1131. This position enjoys ample support. *See, e.g.,* Pintozzi v. Scott, 436 F.2d 375, 378 n.3 (7th Cir. 1970); Kallen v. Nexus Corp., 353 F. Supp. 33, 34 n.1 (N.D. Ill. 1973); 2A MOORE'S FEDERAL PRACTICE ¶ 12.09, at 2313 (2d ed. 1975).

¹² The panel consisted of Judges Friendly, Mansfield, and Mulligan.

¹³ 544 F.2d at 1137 n.18. *See* note 6 *supra*.

definition of a security, "any note" with a maturity of greater than nine months. Since the notes in question had a term longer than nine months, the court stated that "unless the context otherwise requires," they fall squarely within the definitional provision of the 1934 Act.¹⁴ The court also ruled that the party attempting to show that a note is not a security has the burden of proving that the context in which the note was issued takes it out of the ambit of the securities laws.¹⁵

In analyzing the concept of issuance, the Second Circuit looked to both legislative history and judicial precedent for guidance, but found that neither provided suitable, precise guidelines for determining when a promissory note transaction involves a security.¹⁶ Thus, the court formulated its own test. Judge Friendly stated that consumer financing notes, home mortgage notes, secured short-term term loans to small businesses, "character" loans to bank customers, short-term notes secured by accounts receivable, and notes which merely formalize open-account debts "incurred in the ordinary course of business" are the types of notes not intended to fall within the parameters of the 1934 Act.¹⁷ Notes with a maturity exceeding nine months, and not bearing a strong "family resemblance" to those listed, the Second Circuit posited, should be deemed securities for purposes of the 1934 Act.¹⁸

¹⁴ 544 F.2d at 1137.

¹⁵ *Id.* at 1137-38. The Second Circuit stated that "[a] party asserting that a note of more than nine months maturity is not within the 1934 Act . . . or that any note is not within . . . the 1934 Act has the burden of showing that 'the context otherwise requires.'" *Id.* at 1137-38 (footnote omitted) (emphasis in original). Thus, the Second Circuit in effect has shifted to the defendant the burden of proving that the plaintiff's cause of action is not within the ambit of the securities acts. The Second Circuit had adopted this position, notwithstanding that "[i]t is . . . the law that the burden is upon the plaintiff to establish jurisdiction . . . and . . . prove . . . the purchase or sale of a security." *Stevens v. Vowell*, 343 F.2d 374, 378 (10th Cir. 1965). See also *Rekant v. Desser*, 425 F.2d 872, 879 (5th Cir. 1970). The Second Circuit itself has previously remarked that "it is well settled that plaintiffs always have the burden of proving jurisdiction." *Central Mex. Light & Power Co. v. Munch*, 116 F.2d 85, 87 (2d Cir. 1940).

¹⁶ See 544 F.2d at 1137-38.

¹⁷ *Id.* at 1138.

¹⁸ *Id.* Although the Second Circuit believed that its test presented a more acceptable approach to this issue than had previously been proposed, the court recognized that it would not "afford complete certainty." *Id.* A more viable solution, Judge Friendly asserted would be for Congress to change the exclusions to encompass "a note or other evidence of indebtedness issued in a mercantile transaction," as is proposed in the ALI's Federal Securities Code, § 297(b)(3), and complement this by a grant of power to the SEC to explicate the quoted phrase by rule much as § 216A of the ALI Code does with respect to the exemption for commercial paper. . . .
Id. (footnote omitted).

Examining the Weis notes in light of the novel "family resemblance" test, the *Touche Ross* court concluded that they lacked sufficient resemblance to this "family" of "mercantile" transactions to be excluded from the coverage of the securities laws.¹⁹ Most significant among the factors listed by the panel as determinative of its decision were the subordination of the notes to claims of other general creditors and the apparent use of the proceeds from the notes as "equity capital."²⁰ Concluding that *Touche Ross* had failed to prove that "the context otherwise requires," Judge Friendly held the notes to be securities within the meaning of the 1934 Act.²¹

In determining the status of notes evidencing bank loans, other circuits have almost universally found that they are not securities within the purview of the securities acts, notwithstanding whether the bank or borrower was the party claiming to have been defrauded. These courts have focused on the economic realities underlying the issuance of a note. They have attempted to determine whether an instrument arose in an "investment" context or in an ordinary "commercial" transaction: if the note is found to evince an investment it is a security, whereas if it stemmed from an ordinary commercial transaction it is not.²² Although the other circuits are fairly uniform in applying this investment-commercial dichotomy to ascertain whether a note is a security, the specific criteria utilized in the application of this test varies from circuit to circuit.

In *Bellah v. First National Bank*,²³ for example, the Fifth Circuit held that a note with a six-month maturity date issued in exchange for a bank loan was not a security. In so holding, the court stated that the maturity date of less than nine months was not determinative.²⁴ The crucial determination, according to the *Bellah*

¹⁹ The court stated: "If ours is the correct approach, affirmance is clearly demanded The Weis transaction is at the opposite pole from the typical 'mercantile' transactions we have mentioned." *Id.*

²⁰ For a discussion of the other factors which prompted the Second Circuit's decision, see notes 50-56 and accompanying text *infra*.

²¹ 544 F.2d at 1138-39.

²² See, e.g., *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); *McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); *Lino v. City Investing Co.*, 487 F.2d 689 (3rd Cir. 1973). *Cf. Great W. Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976) (*per curiam*) (risk capital test).

²³ 495 F.2d 1109 (5th Cir. 1974).

²⁴ *Id.* at 1111. In concluding that the maturity date is not dispositive of the definitional issue, the Fifth Circuit stated: "[T]he mere fact that a note has a maturity of less than nine months does not take the case out of Rule 10b-5, unless the note fits the general notion of 'commercial paper'. . . ." *Id.*, quoting *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 800 (2d Cir. 1973).

court, was whether the note could be "characterized as commercial rather than investment in nature."²⁵ Since the purpose of the transaction was merely to aid the borrowers in carrying on their business, and no evidence existed to show that the bank was seeking to profit from the successful operation of the borrowers' enterprise, the court concluded that the note was commercial rather than investment paper, and thus outside the scope of the securities laws.²⁶

Similarly, in *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*,²⁷ another bank loan case, the Seventh Circuit stated: "[t]he ultimate question is whether the plaintiffs are simply borrowers in a commercial transaction who are not protected by the 1934 Act or investors in a securities transaction who are protected."²⁸ Although citing with approval certain suggested criteria for making this determination,²⁹ the Seventh Circuit felt that a case-by-case determination is the most efficacious approach.³⁰ The factors which led the *C.N.S. Enterprises* court to conclude that the notes before it were not securities were that the impetus for the transaction came from the borrowers³¹—the bank did not request that the borrowers involve the bank in an investment—and that the plaintiffs operated the business solely in their own behalf.³²

²⁵ 495 F.2d at 1112-13.

²⁶ *Id.* at 1113.

²⁷ 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975).

²⁸ 508 F.2d at 1355.

²⁹ *Id.* at 1361, *citing* 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, 510-24 (1973).

³⁰ 508 F.2d at 1362.

³¹ *Id.* at 1359. When a borrower approaches a financial institution seeking a loan, neither he nor the institution enters into an investment transaction. In funding the borrower's loan, the financier is purchasing commercial paper. *See Sanders v. John Nuveen & Co.*, 463 F.2d 1075, 1080 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972). It should be noted, however, that other courts applying the investment-commercial dichotomy have not found this factor significant. *E.g.*, *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252, 1258 n.5 (9th Cir. 1976) (*per curiam*) (private party may initiate financial transaction to acquire an investment). The "impetus for the transaction" factor is undoubtedly most useful where a commercial lender is a party to the transaction. *Cf. id.* at 1260-62 (Wright, J., concurring) (notes given by borrowers in return for bank loans should not be considered securities).

³² 508 F.2d at 1362-63. The commercial-investment dichotomy was also applied in *Thorp Commercial Corp. v. Northgate Indus., Inc.*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94, 929 (D. Minn. 1974), in which a commercial lender was the plaintiff. The lender alleged that the defendant borrower had fraudulently misrepresented its financial condition and the accounts receivable it had assigned as collateral. The court found that there was no jurisdiction under the securities acts because the notes given the lender were ordinary commercial paper. In its analysis and review of other promissory note definition cases, the *Thorp* court particularly emphasized that investment notes are created by an offering to investors,

Great Western Bank & Trust v. Kotz,³³ decided only two months before *Touche Ross*, also involved a plaintiff bank invoking the securities acts in an attempt to recover on a note unpaid by a bankrupt corporation. In *Great Western*, the Ninth Circuit viewed the pertinent inquiry to be "whether the funding party invested 'risk capital.'"³⁴ The court distinguished "risk capital" from a "risky loan," characterizing the former as an investment and the latter as a commercial transaction.³⁵ In analyzing the transaction pursuant to this test, the *Great Western* court noted that the actual form of the transaction is not controlling, but rather is only one of several factors to be considered.³⁶ Among the other factors given great weight by the Ninth Circuit were the length of the note term, the extent of collateralization, and the relationship between the amount of the loan and the borrower's total assets.³⁷ The court also maintained that a transaction involving a single noteholder, especially

as opposed to a borrower approaching a bank, an acquisition of investment assets in exchange for the notes, and an intent by the investor to participate in the profits of the enterprise obtaining the funds. *Id.* at 97, 212.

³³ 532 F.2d 1252 (9th Cir. 1976) (per curiam).

³⁴ *Id.* at 1257.

³⁵ *Id.* The *Great Western* court's analysis is a further clarification of the risk capital test originally developed by state courts in California and Hawaii and subsequently adopted and extended by several federal courts, primarily in the Ninth Circuit. This test focuses on transactions where funds have been subjected to the risk of an enterprise over which the allegedly defrauded party exercised little control. It is distinguishable from the investment contract test developed in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), in that a security may be found to exist although the *Howey* test is not completely satisfied: an enterprise may not be common, but primarily or solely that of the promoter or the investor, and profits may be derived partially or entirely from the efforts of the investor himself. For example, in *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961), sales of country club memberships to finance club improvements were held to be securities although the members were not to receive a share in club profits. Similarly, in *State v. Hawaii Market Center, Inc.*, 52 Haw. 642, 485 P.2d 105 (1971), the court found a security to exist because although the founder-members of a franchised sales operation exercised some control and depended on their own effort for profits, their purchase of "wholesale" goods to resell to their recruited distributors was essentially the financing of the umbrella enterprise. *Accord*, *SEC v. Glenn W. Turner Enterprise, Inc.*, 348 F. Supp. 766 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973) (pyramid sales scheme in which franchisor was financed through franchisees who were dependent on their own efforts to recruit distributors and sales people). See Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219 (1974). The Supreme Court has neither rejected nor endorsed the risk capital approach. See *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 857 n.24 (1975).

³⁶ 532 F.2d at 1258.

³⁷ *Id.* at 1257-58. In applying these criteria, the court pointed out that the shorter the term of the note, the greater the collateral, and the smaller the loan in relation to the borrower's total assets, the smaller the risk contemplated and the more likely that the note is a commercial rather than investment instrument. *Id.*

one engaged in the lending business, is indicative of a commercial transaction, whereas the issuance of promissory notes to a large number of individuals, especially where they are not individually negotiated, tend to imbue the notes with an investment character. Finally, the court pointed to the contemplated use of the proceeds as indicative of the nature of the transaction. Where the borrowed funds are expended for current operations, *i.e.*, are used as working capital, they are returnable more rapidly than those used to acquire fixed assets, and thus the loan entails both a lesser contemplated risk and a smaller commitment to the long-term success of the enterprise.³⁸

Although the Supreme Court has not yet had the opportunity to render a definitive ruling on the status of promissory notes, it has endorsed an economic reality approach in other cases involving the definition of a security. Recently, in *United Housing Foundation, Inc. v. Forman*,³⁹ the Court was faced with the question whether shares of stock in a cooperative apartment were securities within the definitional sections of the securities laws. According to the Court, the essential issue was whether underlying facts evinced an investment or commercial transaction. To make this determination the Court applied the criteria it had developed in *SEC v. W.J. Howey Co.*⁴⁰ There, the Court had declared that an investment contract "involves an investment of money in a common enterprise with profits to come solely from the efforts of others."⁴¹ Finding that the impetus for the shareholders' purchase was the acquisition of a residence rather than an expectation of profits, the *Forman* Court held that the cooperative shares were not securities.⁴²

While noting the value of the *Howey* test with respect to certain types of instruments, the *Touche Ross* court failed to see its relevance to determining the status of a promissory note. The Second Circuit noted that if there is a common enterprise in a promissory note situation, it is created by the debt relationship.⁴³ Finding interest on a loan to be equivalent to profits expected solely from the efforts of others, the court contended that the *Howey* test would be satisfied by a short term unsecured bank loan to an individual, a

³⁸ *Id.* at 1257-59.

³⁹ 421 U.S. 837 (1975). The court declared: "Because securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto." *Id.* at 849.

⁴⁰ 328 U.S. 293 (1946).

⁴¹ *Id.* at 301.

⁴² 421 U.S. at 853.

⁴³ 544 F.2d at 1136-37.

type of loan surely not intended to enjoy the protection of the securities acts.⁴⁴ It is submitted that this reasoning is not convincing. Although admittedly unsecured short-term bank loans were not intended to be covered by the acts, application of the *Howey* test to promissory notes does not necessitate such a result. Other courts have held that only where commercial lenders receive "profits" extrinsic to the interest charged is the *Howey* test satisfied.⁴⁵ This view of the *Howey* test takes cognizance of the economic realities and thereby focuses on those transactions which the securities acts were intended to cover. Thus, applying the test would not mandate, as Judge Friendly indicated, a finding that all debt instruments are securities.

The Second Circuit then examined the approach utilized by the *Great Western* court. It dismissed the Ninth Circuit's "risk capital-risky loan" distinction by stating that relatively riskless debentures are clearly securities while risky short-term character loans are not.⁴⁶ The Ninth Circuit's criteria, however, are not designed to determine the investment or commercial nature of a transaction on the basis of the actual risk to the lender. Rather, the criteria are directed at determining whether the contemplated risk has the characteristics of a commercial or investment risk. A long-term loan providing the borrower with a large percentage of his assets and used for fixed investment implies a long-term commitment and therefore has the attributes of risk capital. Thus, it may be considered a security. Conversely, a short-term note, the proceeds of which are used for working capital, implies the limited risk generally associated with a commercial loan transaction and thus usually would

⁴⁴ *Id.* There seems to be general agreement with this statement, particularly when the loan proceeds are used for consumer transactions. See, e.g., *Zabriskie v. Lewis*, 507 F.2d 546, 551 (10th Cir. 1974); *McClure v. First Nat'l Bank*, 497 F.2d 490, 494-95 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975). Aggrieved consumers are now protected by the Truth in Lending Act, 15 U.S.C. §§ 1601-1691d(g) (1970 & Supp. V 1975). Nonconsumer short term loans seem to be excluded on the basis of being commercial rather than investment transactions, though there are no reported cases exactly on point. See, e.g., *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354, 1359 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975).

⁴⁵ E.g., *Thorp Commercial Corp. v. Northgate Indus. Inc.*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,929 (D. Minn. 1974); see *Burrus, Cootes & Burrus v. MacKethan*, 537 F.2d 1262, 1264-65 (4th Cir. 1976) (profits distinguished from interest in holding bank certificate not a security). Although the distinction between profits and interest has not been explicitly developed in other security definition cases, it has at least been strongly inferred. In *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 208 (1976), the Court, in finding a flexible fund annuity to be an investment contract and thus a security, pointed out that the promised benefits were not the fixed returns of the usual annuity contracts, but partly dependent on the investment success of the insurance company.

⁴⁶ 544 F.2d at 1136.

not be a security. The former may involve less absolute risk of loss than the latter, as the Second Circuit correctly observed, but this is not determinative for the "risk capital-risky loan" analysis.⁴⁷

Having rejected the existing tests for determining whether a note is a security, the court formulated its own "family resemblance" test. It would appear, however, that this test is merely a listing of what the *Touche Ross* panel believes are promissory notes that should not be considered securities.⁴⁸ The Second Circuit delineated no clear criteria for determining which instruments resemble this "family" of mercantile transactions excluded from the coverage of the securities acts. Any possible precedential value this test might have is further vitiated by the fact that some members of this favored "family" of notes, such as second mortgage loans on residential properties, have in fact been held to be securities by other courts.⁴⁹

It is submitted that an examination of the Weis notes in terms of either the investment-commercial dichotomy test, the *Great Western* test, or the *Howey* test would provide a more logical framework than that adopted by the *Touche Ross* panel and would dictate a result contrary to that arrived at by the Second Circuit. The notes were short term, ranging from twelve to eighteen months, due at maturity or later on six months' written notice tendered by the lender. They were but a small proportion of Weis' total financing.⁵⁰ Under the *Great Western* approach,⁵¹ these factors indicate the tem-

⁴⁷ The *Great Western* court declared: "In the context of this case we must distinguish between the 'risky loan' and 'risk capital.'" 532 F.2d at 1257 (citation omitted). "To determine whether the transaction under review involves . . . 'securities' . . . we analyze the nature and degree of risk accompanying the transaction to the party providing the funds." *Id.* at 1256. The quantum of risk by itself is not dispositive, and the analysis is made as of the time the instrument is created, so that whether a transaction turned out to have been very risky or not is not determinative as a matter of law. "[S]ubsequent conduct cannot retroactively affect the nature of the instrument first received. . . ." *Id.* at 1260.

⁴⁸ 544 F.2d at 1137-38.

⁴⁹ *E.g., Farrell v. United States*, 321 F.2d 409 (9th Cir. 1963), *cert. denied*, 375 U.S. 992 (1964); *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961). The defendants in these cases offered for sale trust notes secured by home mortgages. Though literally exempt, these instruments were found to be securities because the underlying transaction promised minimum returns and negotiability, and invited investor reliance on notes selected by the promoters.

⁵⁰ 544 F.2d at 1139. The notes in question were "but a part of a large financing operation conducted by Weis' combining 19 lenders who held subordinated notes, debentures and cash agreements totalling . . ." over \$8.7 million. *Id.*

⁵¹ See text accompanying notes 33-38 *supra*. If the tests suggested in *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354 (7th Cir. 1975), *discussed in text accompanying notes 27-32 supra*, were to be applied, the result would also militate against a finding that the Weis notes are securities.

porary limited risk associated with normal commercial loans, whereas, if viewed in light of *Howey*, they indicate a substantial absence of a "common enterprise." In form, the instruments were notes with an unconditional obligation to pay and with an interest rate fixed in relation to the prime lending rate rather than any level of profits or other standard of performance by the borrower. These two elements illustrate characteristics common to commercial loans rather than investments.⁵² It would seem, moreover, that since no participation in future profits, stock options, or similar benefits attached to the loan, the *Howey* "expected profits from the efforts of others" criterion was not satisfied.⁵³

Upon close examination, the distinguishing characteristics found by the *Touche Ross* court to exist in the transaction before it appear unconvincing. Although the Second Circuit attached weight to the fact that Weis had its own promissory note forms mandated by the New York Stock Exchange,⁵⁴ and that it had negotiated the

⁵² The plaintiff in *Touche Ross* attempted to show that the bank was not merely lending money for an interest return, but was looking for future profits in terms of an expanded business relationship with Weis and its customers. Brief for Appellee at 28-29. Plaintiff did not show how this expectation of future business was different from that of any bank making commercial loans. See M. LAZERE, *COMMERCIAL FINANCING* 33 (1968) (banks normally look to customers for sources of new business). The Second Circuit did not give credence to these assertions in its ruling. 544 F.2d at 1130. For cases involving more than the typical commercial loan, see *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 527 (5th Cir. 1974) (customers of troubled commodity trading firm accepted promissory notes in lieu of cash in expectation that firm would revive and yield greater profits); *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224, 1229 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974) (consideration was tax benefits and investment leverage).

It should be noted, moreover, that a stockbroker's business involves liquid instruments, and hence, under both the "risk capital" test and the *Howey* "common enterprise" criterion, the funds in Weis were used clearly for "working" rather than "investment" capital. See, e.g., *McClure v. First Nat'l Bank*, 497 F.2d 490, 494 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975) (since no investment assets were obtained for notes, they were not securities); *Tri-County State Bank v. Hertz*, 418 F. Supp. 332 (M.D. Pa. 1976) (working capital loans not securities).

⁵³ See note 45 and accompanying text *supra*.

⁵⁴ Additionally, the Second Circuit placed great weight on the bookkeeping procedures imposed by the New York Stock Exchange. In accordance with these procedures, aggregate indebtedness was defined to exclude "liabilities subordinated to general creditors pursuant to a separate agreement approved by the Exchange." 554 F.2d at 1129. Consequently, subordinated indebtedness was listed not as a liability, but rather with stockholder equity in Weis' balance sheet. *Id.* It should be noted that various types of liabilities, not only subordinated loans, are excluded from the term aggregate indebtedness by rule 325 of the New York Stock Exchange. See N.Y.S.E.R. 325(b)(2); Brief for Appellant at 44-45. Moreover, in the context of a bankruptcy case, the Second Circuit itself did not find "legally persuasive" an alleged bankrupt's arguments that similar subordinated noteholders were not creditors but equity investors. *Blair & Co. v. Foley*, 471 F.2d 178, 180 (2d Cir. 1972), *vacated on other grounds*, 414 U.S. 212 (1973).

loan with one of the bank's chief executives rather than a commercial lending officer, these factors do not seem especially significant. Rather, it is not at all uncharacteristic of commercial transactions involving large loans that they be negotiated by high bank officials.⁵⁵ The court also emphasized that the Exchange National loan was part of a large financing operation by Weis. This, however, was not a public offering form of promissory note placement, a transaction whereby numerous persons are offered standardized instruments in pre-set denominations at interest rates fixed by the borrower or the market. If such were the case, the circumstances of issuance would weigh strongly in favor of viewing the notes as investments. Involved here, however, were individual loan negotiations for varying amounts conducted with sophisticated commercial lenders. Indeed, there existed no evidence that loan terms other than those mandated by the Stock Exchange were predetermined.⁵⁶

Thus, applying the tests used by other courts, it appears that the notes in *Touche Ross* are commercial rather than investment instruments,⁵⁷ and are therefore not securities under the acts. In

The Second Circuit in *Touche Ross* also considered the limitation on the Weis' notes transferability as a factor weighing in favor of their being considered an investment. Other courts, including the Supreme Court, have considered such a limitation as more characteristic of a noninvestment security. See, e.g., *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851 (1975); *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224, 1228 (9th Cir.), cert. denied, 419 U.S. 900 (1974). See note 53 *supra*.

⁵⁵ The lending and investment functions of banks are separated by the regulations under which they operate. The Comptroller of the Currency defines the term "investment security" as a "marketable obligation in the form of a bond, note, or debenture which is commonly regarded as an investment security." 12 C.F.R. § 1.3(b) (1976) (emphasis added). No distinction between a bank's lending and investment transactions is made on the basis of which bank official was involved in the negotiations.

⁵⁶ Brief for Appellee at 7-8; Brief for Appellant at 12-14. The interest rate was not only negotiated, but was in fact based on plaintiff bank's fluctuating prime rate.

⁵⁷ The one factor that might weigh in favor of the Weis notes being considered securities is the absence of collateral. Under the *Great Western* approach, see notes 33-38 and accompanying text *supra*, a secured party is considered less dependent on the managerial skills of the borrower because he can look to the collateral in case of default. But this factor has not been considered independently by other courts, and is certainly not dispositive. See, e.g., *C.N.S. Enterprises, Inc. v. G. & G. Enterprise, Inc.*, 508 F.2d 1354, 1361 (7th Cir.), cert. denied, 423 U.S. 825 (1975); *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224 (9th Cir.), cert. denied, 419 U.S. 900 (1974). Thus, the other tests used would not, in the main, support the Second Circuit here.

Some courts have suggested that where equity instruments instead of promissory notes could have been given to reflect the actual transaction or intent of the parties, investment instruments, and thus, securities are involved. E.g., *Zabriskie v. Lewis*, 507 F.2d 546, 551 (10th Cir. 1974); *United States v. Koenig*, 388 F. Supp. 670, 714 (S.D.N.Y. 1974). *But cf. Rekant v. Desser*, 425 F.2d 872, 878 (5th Cir. 1970) (pre-*Bellah* Fifth Circuit literalist opinion: form of security irrelevant since notes are securities). Another factor some courts consider is

looking to the economic realities of each situation to distinguish between commercial and investment instruments, the Supreme Court and the other circuits have developed better approaches for defining a security in promissory note cases than that provided by the Second Circuit's "family resemblance" approach.⁵⁸ It is hoped that the next time it is presented with this issue the Second Circuit will reevaluate its position.

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the transaction impetus. Generally, when a prospective borrower seeks a loan, neither he nor the lender are entering into an investment transaction. See note 31 *supra*. Other courts have considered as one of the determining factors the parties involved. See, e.g., *McClure v. First Nat'l Bank*, 497 F.2d 490, 493 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975) (two-party transaction with investment intent by lender); *Van Arsdale v. Claxton*, 391 F. Supp. 538, 541 (S.D. Cal. 1975) (no public offering and no investment or speculative intent by noteholder); *Crowell v. Pittsburg & Lake E. R.R.*, 373 F. Supp. 1303, 1308 (E.D. Pa. 1974) (notes issued in intercorporate transactions securities when significant public ownership involved); *Davis v. Avco Corp.*, 371 F. Supp. 782, 787 (N.D. Ohio 1974) (promissory notes issued by class of unsophisticated investors). *Contra*, *Bartha v. Rizzo*, 384 F. Supp. 1063, 1067 (S.D.N.Y. 1974) (sophisticated investors as entitled to full disclosure as are others). These approaches are in keeping with the Supreme Court's dictum in *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) that "the definition of security . . . necessarily determines the classes of investments and investors which will receive the [1934] Act's protections."

⁵⁸ The Second Circuit's "family resemblance" test has already been applied by a district court in that circuit. In *Fund of Funds, Ltd. v. Vesco*, [1975-1976 Transfer Binder] FED. SEC. L. REP. ¶ 95,644 (S.D.N.Y. 1976), the court held a forced loan by a subsidiary to a parent corporation to be a security because it did not bear a sufficiently strong family resemblance to an open-account debt incurred in the ordinary course of business. The district court stated it was up to the defendant to prove that "the context otherwise required," noting that in the case before it defendant could have proven that the loan was for a proper corporate purpose. This leads the analysis away from the underlying transaction and into the murky area of corporate mismanagement, far afield from the question of "what is a security" and even beyond the scope of the antifraud provisions of the securities acts.