

**WHEN IS A NOTE A SECURITY? A HISTORICAL  
PERSPECTIVE ON THE SUPREME COURT'S  
ADOPTION OF THE FAMILY RESEMBLANCE  
TEST: *REVES V. ERNST & YOUNG***

INTRODUCTION

In *Reves v. Ernst & Young*,<sup>1</sup> the United States Supreme Court dealt with the issue of whether a demand promissory note was a "security" under the provisions of the Securities Exchange Act of 1934.<sup>2</sup> Although this was the Court's first decision involving a note as a security, the Court had explored other aspects of a security and the Securities Acts in previous cases.<sup>3</sup> Without previous Supreme Court guidance, lower federal courts had developed their own tests for determining when a note was a security.<sup>4</sup>

In *Reves*, the Supreme Court adopted the family resemblance test to determine when a note is a security and announced four standards to be used in applying that test.<sup>5</sup> The family resemblance test is premised on the presumption that a note is a security unless it resembles one of the seven previously exempted categories of notes, or

1. 110 S. Ct. 945 (1990).

2. *Id.* at 948.

3. See *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985) (holding sale of all of the stock of a closely held corporation was a securities transaction) (*see infra* notes 134-49 and accompanying text); *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (holding a business agreement between two private parties and a certificate of deposit were not securities) (*see infra* notes 128-33 and accompanying text); *International Brotherhood of Teamsters, Chauffeurs, Warehousemen & Helpers of America v. Daniel*, 439 U.S. 551 (1979) (holding a noncontributory, compulsory pension plan was not a security) (*see infra* notes 123-27 and accompanying text); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) (holding shares of stock in a nonprofit cooperative housing corporation were not securities) (*see infra* notes 109-22 and accompanying text); *Tcherpnin v. Knight*, 389 U.S. 332 (1967) (holding a withdrawable capital share in a savings and loan association was a security) (*see infra* notes 97-108 and accompanying text); *Securities & Exchange Commission v. W.J. Howey Co.*, 328 U.S. 293 (1946) (holding the offering of units of a citrus grove development coupled with service contracts were offerings of securities) (*see infra* notes 88-96 and accompanying text); *Securities & Exchange Commission v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) (holding sales of assignments of oil leases were sales of securities) (*see infra* notes 78-87 and accompanying text).

4. See *Exchange National Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976) (announcing the literal or family resemblance test) (*see infra* notes 179-90 and accompanying text); *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976) (per curiam) (adopting a risk capital test) (*see infra* notes 170-78 and accompanying text); *Sanders v. John Nuveen & Co., Inc.*, 463 F.2d 1075 (7th Cir. 1972) (enunciating the commercial-investment dichotomy) (*see infra* notes 152-69 and accompanying text).

5. 110 S. Ct. at 951-52. *See infra* notes 236-60 and accompanying text.

alternatively, the party alleging that a particular note is not a security convinces the court to add a new exemption.<sup>6</sup>

This Note reviews the relevant sections of the Securities Act of 1933 and the Securities Exchange Act of 1934 and their pertinent legislative history.<sup>7</sup> Also the Note reviews the previous Supreme Court decisions and doctrines which provide the framework for the inquiry into what is a security,<sup>8</sup> and the tests developed by the lower federal courts.<sup>9</sup> The Note then analyzes the Court's selection of the family resemblance test and the four standards enunciated.<sup>10</sup>

## FACTS AND HOLDING

The Farmer's Cooperative of Arkansas and Oklahoma, Inc. (Co-Op) was essentially a traditional farmer's cooperative.<sup>11</sup> The Co-Op raised some of its funds for business operations by selling promissory or demand notes.<sup>12</sup> The notes were uncollateralized and uninsured, and were offered to both members and nonmembers through the Co-Op newsletter.<sup>13</sup> The newsletter referred to the notes as "investments" and to their marketing as an "Investment Program."<sup>14</sup> The interest rate was adjusted periodically to ensure a rate of return higher than that offered by local financial institutions.<sup>15</sup> The sale of the notes was a continuous activity and no financial data were distributed concurrently with a sale.<sup>16</sup>

Arthur Young & Co., the predecessor to respondent Ernst & Young,<sup>17</sup> was hired by the Co-Op to audit its 1981 and 1982 financial statements.<sup>18</sup> In addition, Arthur Young gave a short presentation at the 1982 and 1983 Co-Op membership meetings at which approximately 350<sup>19</sup> out of the approximately 23,000 members attended.<sup>20</sup> The only financial data disseminated to noteholders or members were condensed financial statements created by Co-Op management and available to attendees.<sup>21</sup> Arthur Young representatives informed

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6. See *infra* notes 185-88 and accompanying text.
  7. See *infra* notes 57-77 and accompanying text.
  8. See *infra* notes 78-149 and accompanying text.
  9. See *infra* notes 150-90 and accompanying text.
  10. See *infra* notes 225-74 and accompanying text.
  11. *Arthur Young & Co. v. Reves*, 856 F.2d 52, 53 (8th Cir. 1988).
  12. *Id.*
  13. *Reves v. Ernst & Young*, 110 S. Ct. 945, 948 (1990).
  14. *Id.*
  15. *Arthur Young*, 856 F.2d at 53.
  16. *Id.*
  17. *Reves*, 110 S. Ct. at 948.
  18. *Arthur Young*, 856 F.2d at 53.
  19. *Id.*
  20. *Reves*, 110 S. Ct. at 947.
  21. *Arthur Young*, 856 F.2d at 53.

attendees that full financial data along with an audit and report were available at the Co-Op offices.<sup>22</sup>

In 1984, the Co-Op filed for bankruptcy and a class of noteholders filed suit against Arthur Young & Co.<sup>23</sup> The petitioners accused Arthur Young of intentionally failing to follow generally accepted accounting principles by overstating the value of a major asset, thereby disguising the insolvency of the Co-Op and inducing the petitioners to purchase the demand notes.<sup>24</sup> The petitioners "asserted that Arthur Young originated fraudulent statements and omissions" in violation of section 10(b) of the Securities Exchange Act of 1934 ("1934 Act") and corresponding state law.<sup>25</sup>

The petitioners prevailed at trial on a jury verdict and received a \$6.1 million judgment.<sup>26</sup> Arthur Young appealed, asserting that because the demand notes did not come within the definition of "securities" in the 1934 Act or state law, the antifraud provisions of the statutes were inapplicable.<sup>27</sup> A panel of the United States Court of Appeals for the Eighth Circuit sustained the appeal of Arthur Young and held that the notes were not securities under either federal or state law.<sup>28</sup> The Supreme Court granted certiorari<sup>29</sup> to decide the issue of "whether the note issued by the Co-Op is a 'security' within the meaning of the 1934 Act."<sup>30</sup>

The Supreme Court initially noted that the definition of a security in the 1934 Act included the phrase "any note."<sup>31</sup> "The term 'security' means *any note*, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement . . . ; *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*. . . ."<sup>32</sup> Nevertheless, the Court stated that this definition could be applied literally because not

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22. *Id.*

23. *Reves*, 110 S. Ct. at 948. The class was comprised of holders of the demand notes issued by the Co-op. *Id.*

24. *Id.*

25. *Arthur Young*, 856 F.2d at 53-54. The current version of this section is at 15 U.S.C. § 78J(b) (1988). The state law alleged to have been violated was § 67-1256 of the Arkansas Securities Act, ARK. STAT. ANN. § 67-1256 (recodified at ARK. CODE ANN. § 23-42-106 (1987)).

26. *Id.* at 53.

27. *Reves*, 110 S. Ct. at 948.

28. *Id.*

29. *Reves v. Arthur Young & Co.*, 109 S. Ct. 3154 (1989).

30. *Reves*, 110 S. Ct. at 948.

31. *Id.* The Securities Exchange Act of 1934, § 3(a)(10) (current version at 15 U.S.C. § 78c(a)(10) (1988)) [hereinafter cited as the 1934 Act].

32. *Id.* (emphasis added). See *infra* note 59 and accompanying text for the unbridged definition.

all notes are used in an investment setting.<sup>33</sup> The Court declared that the phrase "any note" must be analyzed in light of the purpose of Congress in enacting the Securities Acts.<sup>34</sup> The Court reasoned that the purpose of Congress was to regulate investments; therefore, the only notes to be included by the definition were those notes which were investments.<sup>35</sup> Recognizing that the principle in *Landreth Timber Co. v. Landreth*<sup>36</sup> would not be suitable except in applying a literal definition of "note," the Court surveyed available approaches and selected the "family resemblance" test of the United States Court of Appeals for the Second Circuit.<sup>37</sup> Under the family resemblance test, a note is presumed to be a security unless it is shown to have a strong family resemblance to at least one of a previously identified list of non-securities, or the court is convinced it should add a new exception.<sup>38</sup>

The Court then enunciated four standards for determining whether an instrument resembles any of the families which are not securities: (1) the motivations of a reasonable seller and buyer; (2) the plan of distribution; (3) the reasonable expectations of the investing public; and (4) other risk reducing factors, such as other regulatory schemes which render resort to the Securities Acts unnecessary.<sup>39</sup> The same factors could also be used to convince a court to add a new instrument to the exceptions.<sup>40</sup>

Turning to the demand notes in question, the Court applied the family resemblance test using the four standards.<sup>41</sup> First, as to the motivation of seller and buyer, the Court observed that the notes had been sold to raise general business operations capital and were purchased to earn a profit.<sup>42</sup> Thus, the Court stated that "[f]rom both sides, then, the transaction is most naturally conceived as an investment . . . rather than as a purely commercial or consumer transaction."<sup>43</sup> Second, the plan of distribution standard was met because the notes had been offered and sold "to a broad segment of the pub-

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33. *Reves*, 110 S. Ct. at 950.

34. *Id.* (footnote omitted).

35. *Id.* at 949.

36. 471 U.S. 681 (1985). In *Landreth Timber* the Court stated: "Instruments that bear both the name and all of the usual characteristics of stock seem to us to be the clearest case for coverage by the plain language of the definition." *Id.* at 693. See *infra* notes 134-48 and accompanying text.

37. *Reves*, 110 S. Ct. at 950-51.

38. *Id.* at 952.

39. *Id.* at 951-52.

40. *Id.* at 952.

41. *Id.*

42. *Id.*

43. *Id.* at 953.

lic.”<sup>44</sup> The Court pointed out that previous cases had held that the “common trading” requisite is satisfied when a note is offered to the public.<sup>45</sup> Third, the Court stated that “the public’s reasonable perceptions” standard was met because the notes had been advertized as “investments” and part of an “Investment Program,” and there was no reason why a reasonable person would have doubted that characterization.<sup>46</sup> The Court pointed out that it had “consistently identified the fundamental essence of a ‘security’ to be its character as an ‘investment.’ ”<sup>47</sup> Fourth, the Court could find no factor that reduced risk because the notes had been uncollateralized and uninsured and there was no available federal regulatory scheme other than the Acts.<sup>48</sup> Therefore, the Court concluded that the notes offered by the Co-Op were “notes” within the definition of section 3(a)(10) of the 1934 Act.<sup>49</sup>

Addressing the definitional exception for notes which have a maturity of less than nine months,<sup>50</sup> the Court relied again on legislative purpose as a basis for interpretation.<sup>51</sup> Since the purpose of Congress had been to regulate all types of investments to prevent fraud and abuse, the Court said that the demand notes at issue were not within the exception.<sup>52</sup>

Chief Justice Rehnquist, joined by Justices White, O’Connor, and Scalia, wrote an opinion concurring in part and dissenting in part.<sup>53</sup> The Chief Justice concurred in the Court’s adoption of the family resemblance test.<sup>54</sup> However, he disagreed with the Court’s conclusion that the notes at issue were securities.<sup>55</sup> Chief Justice Rehnquist wrote that the notes came within the literal terms of section 3(a)(10) of the 1934 Act and therefore fit the short-term securities exemption.<sup>56</sup>

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44. *Id.*

45. *Id.* (noting *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985); *Tcherepnin v. Knight*, 389 U.S. 332 (1967); *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946)).

46. *Id.* at 948, 953.

47. *Id.* at 953.

48. *Id.*

49. *Id.* The current version of section 3(a)(10) is at 15 U.S.C. § 77b(1) (1988).

50. *See supra* note 31 and accompanying text.

51. *Reves*, 110 S. Ct. at 955.

52. *Id.*

53. *Id.* at 957.

54. *Id.*

55. *Id.* at 960.

56. *Id.*

## BACKGROUND

## THE SECURITIES LAWS

The initial events which ultimately led to the Supreme Court's interpretation of when a note is a security took place during the Great Depression.<sup>57</sup> In the 1930's, there was a general consensus among the Congress, the Executive Branch, and the public that speculation and fraud surrounding dealings in securities were a major cause of the Depression.<sup>58</sup> The result of this consensus was passage of the Securities Act of 1933 ("1933 Act")<sup>59</sup> and the Securities Exchange Act of 1934 ("1934 Act"),<sup>60</sup> and to some extent, the other securities laws.<sup>61</sup>

In dealing with "securities," Congress was concerned with a significant portion of the national economy that had gone awry.<sup>62</sup> That segment included the public financial markets, financial intermediaries, businesses and individuals seeking capital funds, and the investing public.<sup>63</sup> Against the backdrop of the Great Depression, with the large segment of the economy involved, and the private enterprise system itself in doubt,<sup>64</sup> Congress sought to craft laws to remedy the situation and prevent its reoccurrence.<sup>65</sup> The resulting legislation contained broad definitions of securities.<sup>66</sup> Given the size

57. See FitzGibbon, *What is a Security? - A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893, 893 (1980).

58. *Id.*

59. Ch. 38, Title I, 48 Stat. 74 (1933) (current version at 15 U.S.C. §§ 77a to 77aa (1988)). The original bills, proposals, and legislative history, including congressional hearings and debate are reprinted in LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J. Ellenberger & E. Mahar eds. 1973) [hereinafter LEGISLATIVE HISTORY]. See 1 LEGISLATIVE HISTORY, item 1.

60. Ch. 404, Title I, 48 Stat. 881 (1934) (current version at 15 U.S.C. §§ 78a to 78kk (1988)). See 4 LEGISLATIVE HISTORY, *supra* note 59, item 1.

61. FitzGibbon, 64 MINN. L. REV. at 894 n.6. These Acts included: Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1988); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa to 77bbbb (1988); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (1988); Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (1988).

62. FitzGibbon, 64 MINN. L. REV. at 913.

63. *Id.* at 914.

64. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

65. See FitzGibbon, 64 MINN. L. REV. at 913-14.

66. In the 1933 Act, security is defined as follows:

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

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any

of the problem in the market place and the seemingly infinite variation of transactions available, it is not surprising that Congress defined "security," in such generic and encompassing terms. In this way any commercial instrument within the commonly understood concept of a security would be included within the definition.<sup>67</sup> Also inherent in the legislation was the influence of state blue sky legislation.<sup>68</sup> Those state statutes incorporated the common-law view that securities included "written assurances for the return or payment of money."<sup>69</sup> At common-law, any loan, secured or unsecured, including promissory notes, was an investment.<sup>70</sup>

A comparison of the definition of security in the 1933 Act with the definition in the 1934 Act shows an apparent exemption for cer-

interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, 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.

1933 Act § 2(1), 15 U.S.C. § 77b (1988). In the 1934 Act, security is defined as follows:

§ 3. (a) When used in this title, unless the context otherwise requires —

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, 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.

1934 Act § 3(a), 15 U.S.C. § 78c(a) (1988).

67. Rosin, *Historical Perspectives on the Definition of a Security*, 28 S. TEX. L. REV. 575, 577 (1987); H.R. Rep. No. 85, 73rd Cong., 1st Sess., 11 (1933), *reprinted in 2 LEGISLATIVE HISTORY, supra* note 59, item 18 at 11.

68. Landis, 28 GEO. WASH. L. REV. at 31-34. Blue sky laws are defined as:

A popular name for state statutes providing for the regulation and supervision of securities offerings and sales, for the protection of citizen-investors from investing in fraudulent companies. Most blue sky laws require the registration of new issues of securities with a state agency that reviews selling documents for accuracy and completeness. Blue sky laws also often regulate securities brokers and salesmen.

BLACK'S LAW DICTIONARY 173 (6th ed. 1990).

69. Rosin, 28 S. TEX. L. REV. at 609 (citing *Stevens v. Liberty Packing Corp.*, 111 N.J. Eq. 61, —, 161 A. 193, 195 (N.J. Ch. 1932); *People v. Leach*, 290 P. 131, 134 (Cal. Dist. Ct. App. 1930), *aff'd sub nom. Ex Parte Leach*, 215 Cal. 536, 12 P.2d 3 (1932)). The term "security" is a truncated version of "securities for money" which, at common law, included all forms of written debt instruments. Rosin, 28 S. TEX. L. REV. at 578.

70. *Id.* at 612.

tain instruments.<sup>71</sup> One such exemption in the 1934 Act is for "any note . . . which has a maturity at the time of issuance of not exceeding nine months."<sup>72</sup> A similarly worded exemption is contained in section 3(a)(3) of the 1933 Act.<sup>73</sup> An examination of the legislative history of the 1933 Act shows the source of the exemption to be a letter from the Federal Reserve Board proposing an amendment to the original bill.<sup>74</sup> The Board understood that the proposed bill was "intended to apply only to stocks, bonds, debentures, and other similar securities of the kind commonly known as investment securities, which are issued for the purpose of obtaining capital funds for business enterprises and are purchased by persons for investment."<sup>75</sup> Conversely, the Board understood that the bill was "not intended to apply to bankers' acceptances or to short-time paper issued for the purpose of obtaining funds for current transactions in commerce, industry, or agriculture and purchased by banks and corporations as a means of employing temporarily idle funds."<sup>76</sup> The legislative history for the House bill shows that the exemption in the 1933 Act applied to "short-term paper of the type available for discount at a Federal Reserve bank and of a type which rarely is bought by private investors."<sup>77</sup>

71. See *supra* note 66.

72. *Id.* The legislative history of the 1934 Act is silent on this exemption and its source but it is likely it was derived from the same source as the 1933 exemption. See *infra* note 74-77 and accompanying text.

73. Section 3(a)(3) provides in part:

Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:

...

(3) Any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited;

15 U.S.C. § 77c(a)(3) (1988). The exemption in the 1933 Act applies only to the registration and prospectus requirements, and not to the antifraud provisions of the Act. 1933 Act § 12(2) (current version at 15 U.S.C. § 771(2) (1988)).

74. Letter from Chester Morrill, Secretary, Federal Reserve Board, to Honorable Sam Rayburn, Apr. 3, 1933, in *Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73rd Cong., 1st Sess. at 180-81, reprinted in 2 LEGISLATIVE HISTORY, *supra* note 59, item 20 at 180-81; Letter from Chester Morrill, Secretary, Federal Reserve Board, to Honorable D. Fletcher, Apr. 3, 1933, in *Hearings on S.875 Before the Senate Comm. on Banking and Currency*, 73rd Cong., 1st Sess. at 120, reprinted in 2 LEGISLATIVE HISTORY, *supra* note 59, item 21 at 120.

75. *Id.*

76. *Id.*

77. H.R. Rep. No. 85, 73rd Cong., 1st Sess. (1933), reprinted in 2 LEGISLATIVE HISTORY, *supra* note 59, item 18 at 15. See generally Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW. 1567, 1573 (1980) and Note, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362, 392-93 (1972) (discussing the congressional purposes and goals behind the

## SUPREME COURT DECISIONS DEALING WITH THE SECURITIES LAWS

In *Securities and Exchange Commission v. C.M. Joiner Leasing Corp.*,<sup>78</sup> the Court was required to determine if the definition of "security" in the 1933 Act included oil and gas leases.<sup>79</sup> The Joiner Corporation had sought to finance well-drilling on a large tract of land by offering small parcels of the acreage for resale.<sup>80</sup> In finding that the instruments involved were securities, the Court discussed the doctrine to be used in construing a statute.<sup>81</sup>

The Court said that an act must be interpreted in conformity with its dominating purpose as expressed in the general policy of the legislation.<sup>82</sup> Applying this doctrine to the 1933 Act definition of a security, the Court noted that the definition included both instruments with standardized meanings and others with general descriptive designations.<sup>83</sup> The Court stated that, as a matter of law, some instruments are securities because they fit the name or description.<sup>84</sup> However, the Court cautioned:

[T]he reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts," or as "any interest or instrument commonly known as a 'security.'"<sup>85</sup>

The test, the Court said, was that the "character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."<sup>86</sup> This statutory construction doctrine and the principles embodied in the test were to prove recurrent themes in the Court's analysis of subsequent cases.<sup>87</sup>

The Supreme Court's next encounter with the 1933 Act came in

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physical placement of the exemption within the Acts). See also Lizzul, *The Evolution of Bank Term Lending and the Status of Term Notes Under the Federal Securities Laws*, 31 SYRACUSE L. REV. 959, 978-79 (1980) (noting the consequence of that final placement).

78. 320 U.S. 344 (1943).

79. *Id.* at 345-46, 351-52.

80. *Id.* at 346.

81. *Id.* at 350-51.

82. *Id.*

83. *Id.* at 351.

84. *Id.*

85. *Id.*

86. *Id.* at 352-53.

87. See *Tcherepnin v. Knight*, 389 U.S. 332, 338-39 (1967) (holding that a withdrawable capital share in a savings and loan association was a security within the definition in the 1934 Act); *S.E.C. v. Howey*, 328 U.S. 293, 298-99 (1946) (stating that it is immaterial to the finding of a share whether there are formal certificates).

*Securities and Exchange Commission v. W.J. Howey Co.*<sup>88</sup> Critical to the finding of "securities" was the Court's interpretation of the term "investment contract," one of the enumerated instruments in the definition of "security" in the Act.<sup>89</sup> Howey Co. had offered for sale small portions of a citrus grove development along with a service contract for the cultivation and marketing of the fruit, as well as distribution of the net proceeds.<sup>90</sup> The Court noted that the term "investment contract," although undefined in the 1933 Act, was derived from state blue sky laws where the term was also undefined.<sup>91</sup> State courts had crystallized the meaning of the term, utilizing a broad construction so as to provide full protection to the investing public.<sup>92</sup> According to the Court, a key principle applied by the state courts to protect investors under blue sky laws was that "[f]orm was disregarded for substance and emphasis was placed upon economic reality."<sup>93</sup>

The Court formulated a test to determine the existence of an investment contract: "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."<sup>94</sup> The Court stressed that the test "embodies a flexible rather than a static principle . . . capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."<sup>95</sup> The Court also warned that "[t]he statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae."<sup>96</sup>

Twenty-one years after *Howey*, the Court in *Tcherepnin v. Knight*<sup>97</sup> faced the narrow question of whether a withdrawable capital share in a savings and loan association was a "security" under the 1934 Act.<sup>98</sup> This was a class action suit in which over 5000 investors sought to recover in excess of 15 million dollars.<sup>99</sup> This case was the Court's initial interpretation of the definition of security in the 1934

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88. 328 U.S. 293, 294 (1946).

89. *Id.* at 297. See *supra* note 65 and accompanying text. See also Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RESERVE L. REV. 367, 376 (1967) (discussing principles of *Howey*).

90. *Howey*, 328 U.S. at 294-95.

91. *Id.* at 298.

92. *Id.*

93. *Id.*

94. *Id.* at 301.

95. *Id.* at 299.

96. *Id.* at 301.

97. 389 U.S. 332 (1967).

98. *Id.* at 332.

99. *Id.* at 333 & n.2.

Act; however, the Court did not begin with a blank slate.<sup>100</sup> Taking its cue from a statement in the legislative history of the 1934 Act,<sup>101</sup> the Court stated that the definition in the 1933 Act was "virtually identical" to the definition in the 1934 Act.<sup>102</sup> The Court said that the 1934 Act was clearly remedial legislation and therefore should be construed broadly in order to effectuate its purposes.<sup>103</sup> The Court drew upon the economic reality principle from *Howey*<sup>104</sup> and the flexible definition standard from *Joiner*,<sup>105</sup> and applied the *Howey* test<sup>106</sup> to conclude that the capital shares at issue were securities.<sup>107</sup> The Court's melding of both of the definitions in the Acts and the pattern of coverage of both Acts continued in subsequent litigation.<sup>108</sup>

The next important Supreme Court case touching on the scope of the definition of "security" was *United Housing Foundation, Inc. v. Forman*.<sup>109</sup> Involved in *Forman* was a large low-income housing project known as "Co-op City," which was publicly financed and organized as a cooperative.<sup>110</sup> Prospective Co-op City tenants were required to purchase eighteen "shares" in the non-profit corporation at a rate of twenty-five dollars per share.<sup>111</sup> The shares were non-negotiable, non-transferable, non-voting, and could not be pledged or encumbered.<sup>112</sup> The United States Court of Appeals for the Second Circuit had held that the shares were securities on two grounds. First, because the shares were called "stock," they came explicitly within the definitions in the Acts.<sup>113</sup> Second, the transaction could be characterized as an investment contract and therefore fit the *Howey* test.<sup>114</sup>

The Court, noting that the focus of the Acts was on the capital markets, reiterated a traditional statutory construction canon: "[A]

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100. *Id.* at 335.

101. S. REP. NO. 792, 73rd Cong., 2d Sess. 14 (1934), reprinted in 5 LEGISLATIVE HISTORY, *supra* note 59, item 17 at 14 (stating that the definition of security in the 1934 Act was "substantially the same as" in the 1933 Act).

102. *Tcherepnin*, 389 U.S. at 335-36.

103. *Id.* at 336.

104. *Howey*, 328 U.S. at 298. See *supra* note 93 and accompanying text.

105. *Joiner*, 320 U.S. at 351. See *supra* note 85 and accompanying text.

106. *Howey*, 328 U.S. at 301. See *supra* note 94 and accompanying text.

107. *Tcherepnin*, 389 U.S. at 338.

108. See *infra* notes 115, 125, 133, and 135.

109. 421 U.S. 837 (1975). See also Dillport, *Restoring Balance to the Definition of Security*, 10 SEC. REG. L.J. 99, 106 (1982).

110. *Forman*, 421 U.S. at 837, 840-42.

111. *Id.* at 842.

112. *Id.*

113. *Id.*

114. *Id.* at 846 (citing *Forman v. Community Services, Inc.*, 500 F.2d 1246 (2d Cir. 1974)).

thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers."<sup>115</sup> The Court stated that, other than the label "stock," the shares had none of the ordinary characteristics of stock.<sup>116</sup> The Court also reiterated that the *Howey* test applied to an "investment contract" or an "instrument commonly known as a 'security.'"<sup>117</sup> The Court stated that the essential attributes that define a security are embodied in the *Howey* test.<sup>118</sup> The Court declared that "[t]he touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."<sup>119</sup> The Court, for the first time, provided a definition of the term "profits": "either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds. . . ."<sup>120</sup> The Court found that the transaction involved here was commercial dealing because the shares merely represented an item purchased to be used or consumed.<sup>121</sup> By rejecting a literal approach, the Court mandated that flexibility was to be the standard in the interpretation of what constitutes a security.<sup>122</sup>

The Court provided further insights into its concept of the type of investment found in a security transaction in *International Brotherhood of Teamsters, Chauffeurs, Warehousemen, and Helpers of America v. Daniel*.<sup>123</sup> The Court held that a "security" did not include a noncontributory, compulsory pension plan within its definition.<sup>124</sup> In discussing what constitutes an investment, the Court noted that in all previously considered cases a purchaser had given up "tangible and definable consideration" and in return had received a "separable financial interest."<sup>125</sup> The Court pointed out that an investment need not solely be money, but could be in the form of goods or services.<sup>126</sup> Also noteworthy in *Daniel* is the fact that part of the Court's rationale for not extending the coverage of the Acts to include pension plans was the existence of other applicable and com-

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115. *Forman*, 421 U.S. at 849. The Court also reiterated that the definitions in the 1933 Act and the 1934 Act were virtually identical. *Id.* at 847 n.12.

116. *Id.* at 851.

117. *Id.* at 852.

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.* at 840, 858-60.

122. Dillport, 10 SEC. REG. L.J. 99, 106 (1982).

123. 439 U.S. 551, 558-62 (1979).

124. *Id.* at 570.

125. *Id.* at 559-60. The Court also reiterated that the definitions of a security in the 1933 Act and the 1934 Act were virtually identical. *Id.* at 556 n.7.

126. *Id.* at 560 n.12.

prehensive legislation.<sup>127</sup>

In *Marine Bank v. Weaver*,<sup>128</sup> the Court appeared to limit the reach of the Securities Acts, noting that Congress had not intended "a broad federal remedy for all fraud."<sup>129</sup> At issue in *Marine Bank* was a conventional \$50,000 certificate of deposit pledged to secure a loan to Columbus Packing Co. and a private business agreement between the owners of Columbus Packing and the owners of the certificate.<sup>130</sup> The Court, finding that neither the certificate of deposit nor the business agreement was a security as defined in the 1934 act, noted several facts. First, other federal legislation protected and regulated certificates of deposit; second, this was a private transaction; and finally, there was no public offering or prospectus.<sup>131</sup> The Court cautioned that not all certificates of deposit or business agreements could be considered non-securities per se; rather, the contents of the instrument, its intended purposes, and the overall factual setting were to be evaluated.<sup>132</sup> The Court also noted that the definitional section of the 1934 Act was prefaced such that instruments that came within the terms of the definition would be excluded from "security" if "the context otherwise requires."<sup>133</sup>

A recent case in which the Court considered what constitutes a securities transaction was *Landreth Timber Co. v. Landreth*.<sup>134</sup> In *Landreth*, the Court was required to decide whether the sale of 100 percent of the shares in Landreth Timber Co., a closely held corporation, involved the sale of stock within the definition of a security

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127. *Id.* at 569-70 (referring to the Employee Retirement Income Security Act of 1974, 88 Stat. 829, 29 U.S.C. §§ 1001 to 1461 (1988)).

128. 455 U.S. 551 (1982).

129. *Id.* at 556 (citing *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252, 1253, 1260 (9th Cir. 1976); *Bellah v. First National Bank of Hereford, Texas*, 495 F.2d 1109, 1114 (5th Cir. 1974)).

130. *Marine Bank*, 455 U.S. at 552-53.

131. *Id.* at 558-60.

132. *Id.* at 560 n.11.

133. *Id.* at 556, 558-59. At least one commentator believes that the phrase "context over text" is a congressionally mandated method of statutory construction. 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, 486 (1973). Accord *Exchange Nat'l Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1133 (2nd Cir. 1976) (specifically referencing the Comment while announcing its "family resemblance test"). E.g., *McClure v. First Nat'l Bank of Lubbock, Tex.*, 497 F.2d 490, 493 (5th Cir. 1974); *Zabriskie v. Lewis*, 507 F.2d 546, 551 (10th Cir. 1974). *But see Amer. Bankers Ass'n v. S.E.C.*, 804 F.2d 739, 753-54 (D.C. Cir. 1986); *Ruefenacht v. O'Halloran*, 737 F.2d 320, 330-32 (3rd Cir. 1984); *S.E.C. v. Nat'l Securities, Inc.*, 393 U.S. 453, 466 (1969) (discussing the phrase "unless the context otherwise requires" and stating "Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws"). The same prefatory language appears in the 1933 Act. See *supra* note 66. The Court also stated that the definition of a security in the 1933 Act was essentially the same as in the 1934 Act. *Marine Bank*, 455 U.S. at 555 n.3.

134. 471 U.S. 681, 683 (1985).

under the 1934 Act.<sup>135</sup> The respondents had contended that the principles in *Forman*<sup>136</sup> and its predecessor, *Tcherepnin*,<sup>137</sup> as well as *Marine Bank*<sup>138</sup> and *Teamsters v. Daniel*,<sup>139</sup> mandated that the label "stock" was not determinative, rather, it was necessary to look at the economic realities of the transaction.<sup>140</sup> The Court rejected this view, finding that "[i]nstruments that bear both the name and all of the usual characteristics of stock seem to us to be the clearest case for coverage by the plain language of the definition" of a security.<sup>141</sup> Consequently, a determination of the coverage of the Acts does not necessarily require investigation beyond the instrument itself.<sup>142</sup> The Court pointed out that the *Howey* test was enunciated specifically for an "investment contract" and not for all the instruments listed in the definition of a security in the Acts.<sup>143</sup>

Although the Court seemed to limit the *Howey* test by allowing proof of a security by the stock itself, the Court explicitly refused to adopt such a rule for "notes" or other enumerated categories in the definitions.<sup>144</sup> Specifically, the Court said that the term "'note' may now be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context."<sup>145</sup> The Court's discussion also made it clear that the Acts could cover transactions that were privately negotiated and that investors need not be solely passive investors.<sup>146</sup> Additionally, the Court said that it was proper for courts to include policy considerations when interpreting portions of the Acts.<sup>147</sup>

In deciding *Reves v. Ernst & Young*, the Court candidly stated that it was "fair to say that our cases have not been entirely clear on the proper method of analysis for determining when an instrument is a 'security.'"<sup>148</sup> It is not surprising, therefore, that the lower federal

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135. *Id.* at 683-84. The Court reiterated that the definitions of a security in the 1933 Act and the 1934 Act were virtually identical. *Id.* at 686 n.1.

136. *Forman*, 421 U.S. 837 (1975). *See supra* notes 109-22 and accompanying text.

137. *Tcherepnin*, 389 U.S. 332 (1967). *See supra* notes 97-108 and accompanying text.

138. *Marine Bank*, 455 U.S. 551 (1982). *See supra* notes 128-33 and accompanying text.

139. *Daniel*, 439 U.S. 551 (1979). *See supra* notes 123-27 and accompanying text.

140. *Landreth*, 471 U.S. at 689-92, 689-90 n.4 and 691 n.5.

141. *Id.* at 693.

142. *Id.* at 690.

143. *Id.* at 691.

144. *Id.* at 694.

145. *Id.* (citing *Securities Industry Ass'n v. Board of Governors*, 468 U.S. 137, 149-53 (1984)).

146. *Landreth*, 471 U.S. at 692.

147. *Id.* at 694-95 n.7.

148. *Id.* at 688.

courts developed various tests to determine if a given "note" was a security.<sup>149</sup>

#### THE FEDERAL COURTS OF APPEALS APPROACHES TO NOTES AS SECURITIES

Under the nebulous and sometimes seemingly contradictory guidance emanating from the Supreme Court as to what was or was not a "security" under the 1933 and 1934 Acts, United States Courts of Appeals had developed various tests to determine whether or not a note was a security.<sup>150</sup> These tests fell into three categories.<sup>151</sup>

The commercial/investment test has been used in the largest number of Courts of Appeals, including the First,<sup>152</sup> Fifth,<sup>153</sup> Seventh,<sup>154</sup> and Tenth<sup>155</sup> Circuits.<sup>156</sup> The first enunciation of the commercial/investment test came in *Sanders v. John Nuveen & Co.*<sup>157</sup> The issue in *Nuveen* was whether short-term commercial paper could be characterized as a security within the 1934 Act despite having a maturity not exceeding nine months.<sup>158</sup> Commercial paper in the form of promissory notes had been issued by Winter & Hirsch, Inc., purchased by Nuveen at a discount, and offered by Nuveen to investors at a different discount rate.<sup>159</sup> The court recognized Supreme Court guidance: remedial legislation is to be construed flexibly and liberally;<sup>160</sup> the definition of a security is broad enough to encompass various instruments;<sup>161</sup> the substance of economic reality is paramount to form;<sup>162</sup> and comparison of the definition of "security" in the various related laws is approved.<sup>163</sup> After reviewing the definition in related legislation and congressional purposes,<sup>164</sup> the court

149. *Reves v. Ernst & Young*, 100 S. Ct. 945, 950-51 (1990).

150. *Futura Development Corp. v. Centex Corp.*, 761 F.2d 33, 39-40 (1st Cir. 1985). See *supra* note 148 and accompanying text.

151. See *infra* notes 152-90 and accompanying text.

152. *Futura*, 761 F.2d at 33, 40.

153. *McClure*, 497 F.2d at 490. See also *infra* note 157 and accompanying text.

154. *Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984).

155. *Holloway v. Peat, Marwick, Mitchell & Co.*, 879 F.2d 772, 778-79 (10th Cir. 1989).

156. *Reves*, 110 S. Ct. at 950.

157. 463 F.2d 1075 (7th Cir. 1972); *Lizzul*, 31 SYRACUSE L. REV. at 991.

158. *Nuveen*, 463 F.2d at 1076.

159. *Id.* at 1076, 1080.

160. *Id.* at 1077 (quoting *S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)).

161. *Nuveen*, 463 F.2d at 1077 (quoting *Howey*, 328 U.S. at 299). See *supra* notes 88-96 and accompanying text.

162. *Nuveen*, 463 F.2d at 1077 (quoting *Tcherepnin*, 389 U.S. at 336). See *supra* notes 97-108 and accompanying text.

163. *Nuveen*, 463 F.2d at 1077-78 (citing *Tcherepnin*, 389 U.S. at 335-36, 338 and *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972)).

164. *Nuveen*, 463 F.2d at 1078-80. See *supra* note 61 and accompanying text.

concluded that the definitional exclusion in the 1934 Act of a note with maturity of not exceeding nine months was not applicable to commercial paper offered for investment purposes.<sup>165</sup>

Further elaboration of the commercial/investment test came in *McClure v. The First National Bank of Lubbock, Texas*.<sup>166</sup> The promissory note involved in *McClure* had a one-year term, clearly beyond the nine month limit in the definition, and was given along with a trust deed to obtain a bank loan.<sup>167</sup> In reviewing prior cases involving notes, the court recognized that those transactions involving securities shared three characteristics: First, there was "some class of investors," second, the notes were "acquired . . . for speculation or investment," and third, the proceeds were used to "obtain investment assets, directly or indirectly."<sup>168</sup> Applying the factors to the case at hand, the court found that the note was privately negotiated for the commercial purpose of paying business debts and, therefore, was not a security.<sup>169</sup>

The United States Court of Appeals for the Ninth Circuit developed the "risk capital" test, which attempts to differentiate between a "risky loan" and "risk capital."<sup>170</sup> The court announced this test in *Great Western Bank and Trust v. Kotz*.<sup>171</sup> At issue in *Kotz* was a demand note with a ten-month maturity and renewal for one year periods if the parties agreed.<sup>172</sup> The note was accompanied by a stringent loan agreement which provided in part that the borrowed funds could only be used as working capital, the bank could inspect the borrower's books upon reasonable request, the approval of the bank was required for any further unsecured borrowing, and the borrower's business dealings were severely limited.<sup>173</sup> The court said that the nature and degree of risk to the lender must be analyzed in determining whether the transaction was an investment.<sup>174</sup> The key inquiries, the court said, were whether risk capital had been invested by the lender and whether, if risk capital, it was subject to the "entrepreneurial or managerial efforts of [others]."<sup>175</sup> The court enumerated a list of factors to consider in a risk capital inquiry.<sup>176</sup> The

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165. *Id.* at 1079-80.

166. 497 F.2d 490, 492-95 (5th Cir. 1974).

167. *Id.* at 491-92.

168. *Id.* at 493-94.

169. *Id.*

170. Lizzul, 31 SYRACUSE L. REV. at 996.

171. 532 F.2d 1252, 1257 (9th Cir. 1976) (per curiam).

172. *Id.* at 1254.

173. *Id.* at 1254-55.

174. *Id.* at 1256.

175. *Id.* at 1257 (citing *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852 (1975)).

176. *Great W. Bank*, 532 F.2d at 1257-58.

most important factor was the term of the note.<sup>177</sup> Other factors included whether the notes were collateralized, the form of the obligation, the plan of issuance, the amount borrowed related to the size of the business of the borrower, and how the borrowed funds were to be used.<sup>178</sup>

In *Exchange National Bank of Chicago v. Touche Ross & Co.*,<sup>179</sup> the United States Court of Appeals for the Second Circuit announced the "literal" or "family resemblance" test.<sup>180</sup> The promissory notes at issue were three unsecured, subordinated notes issued by a brokerage firm and which had a maturity ranging from twelve to eighteen months.<sup>181</sup> The Bank alleged that it had relied on the opinion of the respondent of the financial position of the brokerage firm and that the conduct of the respondent violated various anti-fraud provisions of the 1933 and 1934 Acts.<sup>182</sup> A central contention of the defendant was that the notes were not securities under the securities laws.<sup>183</sup> After reviewing the Acts, their legislative history, some topical commentaries, and other federal approaches, the court determined that the best approach was to adhere to the statutory definition.<sup>184</sup> In other words, the court said, "the plain terms of both acts [are] to be applied 'unless the context otherwise requires.'"<sup>185</sup> Under the approach of the Second Circuit, the definition of a "security" would be applied to the notes in question unless a party could prove that the context required otherwise.<sup>186</sup> The court, without explanation or discussion, listed six transactions where the context would require otherwise:

The note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized).<sup>187</sup>

To escape the coverage of the Acts, a party would need to show that

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177. *Id.* at 1257.

178. *Id.* at 1258.

179. 544 F.2d 1126 (2d Cir. 1976).

180. See Lizzul, 31 SYRACUSE L. REV. at 999; Sonnenschein, 35 BUS. LAW at 1602; *Reves*, 110 S. Ct. at 950.

181. *Exchange Nat'l Bank*, 544 F.2d at 1128, 1138.

182. *Id.* at 1127-28.

183. *Id.* at 1128.

184. *Id.* at 1131-37.

185. *Id.* See *supra* note 133 and accompanying text.

186. *Id.* at 1137-38.

187. *Id.* at 1138. The Second Circuit, noting that the list was "not graven in stone,"

the notes at issue had a "strong family resemblance" to the listed exceptions or convince the court that the context otherwise required.<sup>188</sup> The court provided no discussion with its enumeration of exempted categories of notes.<sup>189</sup> However in its examination of the notes at issue, the court noted several factors in concluding that the notes were securities: (1) the subordinated nature of the notes; (2) the proceeds were considered the equivalent of equity capital; (3) the notes were unsecured; (4) the transaction was one of several; and (5) the proceeds were used for business expansion.<sup>190</sup>

## ANALYSIS

With the remedial purpose of the securities laws in mind and the common-law concepts embodied in existing state blue sky laws, Congress clearly intended to incorporate an expansive concept of a security and did not intend to restrict that concept in its definition of a security.<sup>191</sup>

Given the historical context in which the securities laws were enacted, it is not surprising that the primary concern of Congress was investment-type transactions and not commercial or consumer-type loans.<sup>192</sup> The lack of a discussion of commercial transactions in the legislative history of either the 1933 Act or 1934 Act confirms this.<sup>193</sup> The Necessity for Regulation statement in the 1934 Act clearly shows the concerns of Congress.<sup>194</sup> Congress wanted to ensure fair dealing in high volume public transactions carried on in the security exchanges and over the counter markets.<sup>195</sup> Congress noted that "prices established and offered in such transactions are generally disseminated and quoted . . . [and] are susceptible to manipulation and control [or] excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities."<sup>196</sup>

However, the definitions in the Acts and the exemption in the 1933 Act show those congressional concerns ambiguously, because

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later added to the list "notes evidencing loans by commercial banks for current operations." *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 939 (2d Cir. 1984).

188. *Exchange Nat'l Bank*, 544 F.2d at 1138.

189. *Id.* at 1138-39.

190. *Id.*

191. *Rosin*, Historical Perspectives on the Definition of a Security, 28 S. TEX. L. REV. 577, 589 (1987). See also *supra* notes 67-68, 103 and accompanying text.

192. See *supra* notes 57-58 and accompanying text.

193. See LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J. Ellenberger & E. Mahar eds. 1973).

194. 15 U.S.C. § 78b (1988). The Necessity for Regulation Statement is the declaration of purposes and objects of the legislation.

195. *Id.*

196. *Id.*

only the nine-month maturity provision for notes, drafts, bills of exchange, and banker's acceptances indicates the intent of Congress to provide different treatment.<sup>197</sup> The final placement of exemptions reflects congressional recognition of the need for different policies regarding registration provisions in the 1933 Act versus the antifraud provisions of both Acts.<sup>198</sup> While wanting to preserve applicability of the antifraud provisions, Congress recognized that requiring registration for commercial paper would be so time consuming as to essentially destroy its usefulness.<sup>199</sup> Nevertheless, Congress, by placing the exemption in the definition of a security in the 1934 Act but not in the definition of the 1933 Act and yet asserting that the definitions were "substantially the same,"<sup>200</sup> left room for subsequent judicial interpretation.<sup>201</sup> Additionally, since the exemption in the 1933 Act applies only to the registration requirements, the effect of a literal application of the Acts would be to hold all notes, regardless of maturity period, as securities under the 1933 Act fraud provisions, and to hold notes with a maturity of not less than nine months as securities under the 1934 Act as well.<sup>202</sup> Clearly, a literal application of the Acts would be contrary to both the purpose of Congress<sup>203</sup> and previous Supreme Court guidance.<sup>204</sup>

Further complicating the situation are the changes in the commercial paper market.<sup>205</sup> Now that commercial paper is widely marketed and purchased by the general public, much of the rationale for exempting commercial paper has disappeared.<sup>206</sup> Given the current situation, protection under the Acts would be a more rational approach.<sup>207</sup> Congress has shown little interest in amending the definition in the 1934 Act or the exemption in the 1933 Act and therefore, it rests in large part on the federal judiciary to effectuate the con-

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197. See *supra* notes 66, 71-73 and accompanying text.

198. Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW. 1567, 1575 (1980).

199. Note, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362, 393 (1972). See also *supra* note 198 and accompanying text.

200. S. REP. NO. 792, 73rd Cong., 2d Sess., 14 (1934), reprinted in 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, item 17 at 14 (J. Ellenberger & E. Mahar eds. 1973).

201. Lizzul, *The Evolution of Bank Term Lending and the Status of Term Notes Under the Federal Securities Laws*, 31 SYRACUSE L. REV. 959, 977 (1980).

202. *Id.* at 978.

203. See *supra* notes 62-67, 192-99 and accompanying text.

204. *Reves v. Ernst & Young*, 110 S. Ct. 945, 949 (citing *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849). The main purpose underlying the Securities Acts is "to eliminate serious abuses in a largely unregulated securities market." *Reves*, 110 S. Ct. at 949.

205. Note, 39 U. CHI. L. REV. at 389.

206. *Id.* at 396.

207. *Id.*

gressional policy embodied in the Acts.<sup>208</sup>

The *Howey* test left plenty of room for subsequent interpretation because it dealt with the definition of "investment contract" rather than a security per se, the medium of investment was explicitly defined as money, and it left undefined the terms "common enterprise" and "profits."<sup>209</sup>

Given the ambiguity, the changing marketplace, and the lack of definitive Supreme Court guidance as to when a note is a security, it is not surprising that lower federal courts had great difficulty formulating evaluative factors and therefore different tests evolved.<sup>210</sup> This was made manifestly more difficult because a note is an extremely flexible instrument and can be used in a myriad of scenarios.<sup>211</sup> Consequently, courts had to be flexible, and their approaches generally reflected this in their use of vagueness and generalities.<sup>212</sup>

The tests developed by the lower federal courts included lists of evaluative factors for determining when a note is a security.<sup>213</sup> The application of a list of factors has been criticized for entailing a case-by-case approach and contributing to uncertainty in application of the law.<sup>214</sup> Typical of the criticisms are those leveled at the commercial/investment test: (1) the wide variation of factors among various courts; (2) the dearth of guidance as to the rank or relative weight of each factor; and (3) regardless of the factors used or relative weight assigned, the application must be case-by-case to the facts presented.<sup>215</sup> Additionally, by focusing exclusively on the characteristics of the note, the court essentially eliminated from consideration the maturity-length exemption; instead, the court relied entirely on whether the transaction was commercial or an investment.<sup>216</sup> At

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208. *Reves*, 110 S. Ct. at 949.

209. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RESERVE L. REV. 367, 374-75 (1967). See also *supra* note 89 and accompanying text.

210. *Reves*, 110 S. Ct. at 950-51. See *supra* notes 148-49, 205-06. See *infra* note 213 and accompanying text.

211. Sonnenschein, 35 BUS. LAW. at 1578.

212. *Id.* at 1589.

213. See *supra* notes 152-55, 168, 176-78, 189-90 and accompanying text. The United States Courts of Appeals for the Eighth and the District of Columbia Circuits had not evolved or adopted any of the discussed tests but had instead applied the *Howey* test. The Supreme Court rejected this approach since the test was developed for investment contracts. *Reves*, 110 S. Ct. at 950-51.

214. Sonnenschein, 35 BUS. LAW. at 1589; Lizzul, 31 SYRACUSE L. REV. at 1006. See *supra* notes 168, 176-78, 189-90 and accompanying text.

215. Dillport, *Restoring Balance to the Definition of Security*, 10 SEC. REG. L.J. at 99, 111, 111 n.39 & 112 (1982); Lizzul, 31 SYRACUSE L. REV. at 995; FitzGibbon, *What is a Security? — A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893, 938 n.162 & 940 (1980).

216. *McClure v. The First National Bank of Lubbock, Texas*, 497 F.2d 490, 494-95 (5th Cir. 1974).

least one commentator has suggested that the commercial/investment test is the one that is most in consonance with the legislative history of the Acts.<sup>217</sup> At least one court believed that the test met Supreme Court edicts.<sup>218</sup>

No other circuit has adopted the risk capital test.<sup>219</sup> However, the test may be seen as a version of the commercial/investment test because the court noted that differentiating between a risky loan, and risk capital has been framed as the "commercial-investment dichotomy."<sup>220</sup> Although the court said that time was a primary factor among the various factors listed,<sup>221</sup> the test has been criticized for providing inadequate guidance for applying the factors, and requiring a case-by-case approach.<sup>222</sup>

The Second Circuit's approach did not enumerate evaluative factors per se; however, the court did evaluate several factors in its discussion.<sup>223</sup> Therefore, it would seem that, unless the note fits one of the non-security categories, the family resemblance test would require a case-by-case application and be subject to similar criticisms as the commercial/investment test.<sup>224</sup>

While all of the tests of the lower federal courts recognized the central purpose of the Acts in dealing with securities as investments, the Second Circuit's family resemblance test provides the greatest potential for minimizing uncertainty and vagueness in application.<sup>225</sup> The Supreme Court, in adopting the family resemblance test, gave no reasons per se for its adoption.<sup>226</sup> Presumably, there are at least two reasons it is more promising. First, it begins with a presumption of coverage.<sup>227</sup> Second, it lists specific non-security categories.<sup>228</sup> Given the remedial purposes of the Acts, the broad definitions in both Acts and the relatively narrow exemptions, a presumption in favor of coverage better effectuates the underlying policy.<sup>229</sup> The list of instru-

217. Lizzul, 31 SYRACUSE L. REV. at 1002.

218. Futura Development Corp. v. Centex Corp., 761 F.2d 33, 41 (1st Cir. 1985).

219. Sonnenschein, 35 BUS. LAW. at 1595.

220. Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1257 (9th Cir. 1976) (per curiam).

221. *Id.* at 1257-58.

222. Sonnenschein, 35 BUS. LAW. at 1601; Lizzul, 31 SYRACUSE L. REV. at 999.

223. See *supra* notes 189-90 and accompanying text.

224. Lizzul, 31 SYRACUSE L. REV. at 1001. See *supra* note 213 and accompanying text.

225. See *Reves*, 110 S. Ct. at 951. See *infra* notes 214, 222, 224 and accompanying text.

226. *Reves*, 110 S. Ct. at 951. The Court labels the family resemblance test as the "more promising framework for analysis." *Id.*

227. *Id.* at 950.

228. *Id.* at 951.

229. Dillport, 10 SEC. REG. L.J. at 134.

ments which are not considered securities serves two functions.<sup>230</sup> First, the list provides specific examples which assist application and reduce uncertainty compared to vague general factors.<sup>231</sup> Second, the list serves to focus judicial inquiry first to the list itself and then, if needed, to the transaction involved.<sup>232</sup>

As noted earlier, the family resemblance test as developed by the Second Circuit did not provide any specified evaluation factors.<sup>233</sup> The Supreme Court recognized that standards were required which could be used when a note instrument did not fit within the current list.<sup>234</sup> While enunciating the standards, the Court made clear by reference to previous decisions that it intended to be in harmony with previous edicts and a comparison shows that harmony.<sup>235</sup>

The first standard, an assessment of the motivations of reasonable buyers and sellers, looks to the purpose for which each entered the transaction.<sup>236</sup> Was the seller motivated by the intent to raise general business revenues or to purchase other sizable investments?<sup>237</sup> Was the seller interested in minor assets or consumer goods?<sup>238</sup> Was the buyer interested primarily in the profit expected?<sup>239</sup> These are questions that could be asked under the test in *Securities and Exchange Commission v. C.M. Joiner Leasing Corp.*<sup>240</sup> Similarly in *Securities and Exchange Commission v. W.J. Howey Co.*,<sup>241</sup> the Court said that the economic realities of the transaction were critical, and the *Howey* test asked if there was money invested with the expectation of profits.<sup>242</sup> In *Tcherepnin v. Knight*,<sup>243</sup> the Court reaffirmed the importance of the economic realities and the inquiries under the *Howey* test.<sup>244</sup> The Court in *United Housing Foundation, Inc. v. Forman*<sup>245</sup> defined profits to include capital appreciation and participation in earnings, and explained that the touchstone of a security included the expectation of profits.<sup>246</sup>

The explication of profits continued in *International Brother-*

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230. See *supra* note 187 and accompanying text.

231. Sonnenschein, 35 BUS. LAW. at 1604.

232. *Id.* at 1606.

233. See *supra* notes 189-90 and accompanying text.

234. *Reves*, 110 S. Ct. at 951.

235. *Id.* at 951-53.

236. *Id.* at 951.

237. *Id.*

238. *Id.* at 952.

239. *Id.* at 951-52.

240. 320 U.S. 344 (1943). See *supra* notes 78-87 and accompanying text.

241. 328 U.S. 293 (1946). See *supra* notes 88-96 and accompanying text.

242. *Id.* at 298, 301.

243. 389 U.S. 332 (1967). See *supra* notes 97-108 and accompanying text.

244. *Id.* at 336, 338.

245. 421 U.S. 837 (1975). See *supra* notes 109-22 and accompanying text.

246. *Id.* at 852.

hood of *Teamsters, Chauffeurs, Warehousemen and Helpers of America v. Daniel*<sup>247</sup> and now included separable financial interest.<sup>248</sup> The Court also explained that the buyer must give up tangible and definable consideration and that the seller could receive goods and services in addition to money.<sup>249</sup> The fact that an investor is not passive or that the transaction is essentially a private agreement, as in *Landreth Timber Co. v. Landreth*,<sup>250</sup> is not incongruent with the assessment of motivations standard.<sup>251</sup>

The second standard, an examination of the "plan of distribution," is literally taken from *Joiner*,<sup>252</sup> as the Court in *Reves* recognized.<sup>253</sup> Such an examination is in accord with the economic realities edict of *Howey* and *Tcherepnin* and the policy pronouncements in *Forman*.<sup>254</sup>

The examination of "the reasonable expectations of the investing public," the third standard,<sup>255</sup> is embodied in the various pronouncements by the Court in *Joiner*, *Howey*, *Tcherepnin*, *Forman*, and *Landreth Timber* that the Acts reflect congressional purpose — protection of the investing public.<sup>256</sup> The expectation of an investor is one of the economic realities embodied in the *Howey* mandate.<sup>257</sup>

The final standard, the availability of other regulatory legislation or schemes,<sup>258</sup> was explicitly addressed in *Daniel*.<sup>259</sup> A corollary to the use of other available schemes is that the standard reserves resort to the Securities Acts to those situations more aligned to the congressional policy behind them.<sup>260</sup>

The family resemblance test with the factors adopted by the Court is subject to two criticisms. First, the test itself is premised on an apparent misconstruction of the legislative language.<sup>261</sup> Second, the ranking and relative weight of each standard are generally un-

247. 439 U.S. 551 (1979). See *supra* notes 123-27 and accompanying text.

248. *Id.* at 559.

249. *Id.* at 560, 560 n.12.

250. 471 U.S. 681 (1985).

251. *Id.* at 692. See *supra* note 236 and accompanying text.

252. *Joiner*, 320 U.S. at 353.

253. *Reves*, 110 S. Ct. at 952.

254. *Howey*, 328 U.S. at 298; *Tcherepnin*, 389 U.S. at 336; *Forman*, 421 U.S. at 852.

255. *Reves*, 110 U.S. at 952.

256. *Joiner*, 320 U.S. at 351-52; *Howey*, 328 U.S. at 301; *Tcherepnin*, 389 U.S. at 336; *Forman*, 421 U.S. at 849; *Landreth*, 471 U.S. at 687.

257. *Howey*, 328 U.S. at 298-99.

258. *Reves*, 110 U.S. at 952.

259. *Daniel*, 439 U.S. at 569-70.

260. See *supra* notes 191-96 and accompanying text.

261. Sonnenschein, 35 BUS. LAW. at 1577; Dillport, 10 SEC. REG. L.J. at 109 n.35. But 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, 485 (1973).

known.<sup>262</sup> The first is predicated on the prefatory language to the definitions in the Acts.<sup>263</sup> The test is based on application of the statutory definitions unless the context otherwise requires.<sup>264</sup> This phrase itself is taken out of context since it is prefaced in the original bills by the phrase, "when used in this subchapter."<sup>265</sup> The definition given was to be used unless it was contextually incompatible with another section in the law, either the 1933 Act or the 1934 Act.<sup>266</sup> The criticism becomes unimportant because, as used in the test, context is synonymous with the economic realities of the transaction.<sup>267</sup>

The lack of ranking and relative importance for each standard invites the same criticism that is offered for the other tests formulated by the federal courts.<sup>268</sup> The Court's discussion in *Reves* leaves several areas unresolved. For example, in the Court's discussion of the risk reducing standard, it is unclear whether or not the availability of another regulatory scheme would completely preclude resort to the Securities Acts.<sup>269</sup> Similarly, it is unresolved whether the plan of distribution standard is inapplicable or whether a non-security must be present when a transaction involves neither "a broad segment of the public" nor "common trading."<sup>270</sup> Likewise, there is no indication whether the standards are to be ranked equally or whether the Court listed the standards in descending order of importance.<sup>271</sup> Presumably, the reasonable expectations of an investor would be part of the investor's motivation; however, they are treated separately.<sup>272</sup> It would seem that the motivations standard should be paramount since it encompasses at least part of the investor's expectations, and the distribution plan would contribute to the formation of those expectations.<sup>273</sup> Additionally, the motivations assessment requires an examination of the transaction which is similar to the economic realities dogma.<sup>274</sup>

## CONCLUSION

The Court's adoption of the family resemblance test in *Reves v.*

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262. See *supra* notes 168, 176-78, 189-90, 214-15 and accompanying text.

263. See *supra* note 66.

264. See *supra* notes 184-86 and accompanying text.

265. See *supra* note 66.

266. *S.E.C. v. Nat'l Securities, Inc.*, 393 U.S. 453, 466 (1969). See *supra* note 132 and accompanying text. Accord *Sonnenschein*, 35 BUS. LAW. at 1577.

267. *Sonnenschein*, 35 BUS. LAW. at 1577-78.

268. See *supra* notes 215-16, 223, 225 and accompanying text.

269. *Reves*, 110 S. Ct. at 952.

270. *Id.* at 952-53.

271. *Id.* at 951-52.

272. *Id.*

273. *Id.*

274. *Id.* at 951. See *supra* notes 241-42 and accompanying text.

*Ernst & Young*<sup>275</sup> should minimize the uncertainty facing the courts in determining whether a note is a security in a given situation.<sup>276</sup> The presumption that a particular note is a security adheres to congressional policy and conforms to the remedial purposes of the Acts.<sup>277</sup> Placing the burden of showing a non-security on the person seeking to use other persons' money also serves those policies and purposes.<sup>278</sup> The enumeration of non-security families provides a partial bright-line test, and serves to narrow the judicial inquiry.<sup>279</sup> Although further judicial explication may be necessary, the standards adopted provide a good reference from which to determine whether a note is a security when the note does not bear a close family resemblance.

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275. 110 S. Ct. 945 (1990).

276. See *supra* notes 210, 225 and accompanying text.

277. See *supra* notes 62-67, 192-99 and accompanying text.

278. *Id.*

279. Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW. 1567, 1604 & 1606.

