WHAT IS A SECURITY? INDIVIDUALLY NEGOTIATED PROMISSORY NOTES MAY NOT QUALIFY

This past February, California's Court of Appeal for the 6th District directly addressed this question in *People v. Black* and resolved that the individualized and privately negotiated nature of an instrument is but one aspect for courts to consider when examining whether a transaction qualifies as a "security" under California's Corporate Securities Law of 1968 (the "Corporate Securities Law").[1]

Few allegations of commercial impropriety can inflict as severe of reputational injury and generate as much public indignation as do charges of securities fraud. While allegations of securities fraud may likely conjure images of complex financial instruments and pyramid schemes, rarely does one have the occasion to contemplate the definition of a "security", specifically as to the instruments and transactions that qualify for regulation under the securities laws. Although a question of law, no single definition or judicial test is controlling on this matter within California.

I. *PEOPLE V. BLACK*

A. Factual and Procedural Background

Defendant organized and managed a limited liability company, Atherton, LLC ("Atherton") for the purpose of developing and reselling certain real property located in Eagle, Idaho. After contracting to purchase the property, defendant executed and personally guaranteed a promissory note on behalf of Atherton to secure $124,456 in additional funding from a private investor. One year later, the investor agreed to contribute an additional $155,474 in funds and extend the maturity date by one year. Twice thereafter the investor would agree to extend the note's maturity date without contributing additional funding, finally becoming due in mid-January 2012.

In order to induce investment and minimize the investor's risk of loss, the original note contained highly-individualized repayment terms which varied according to whether Atherton sold, developed, or failed to develop or sell the underlying property within one year following the note's execution. Thus, if the property were developed, the investor would receive two lots as repayment, whereas if the property sold, the investor would receive interest in an amount equivalent to the percentage of profit realized by Atherton (excluding expenses). Lastly, but most importantly for the court's analysis, if Atherton failed to either develop or sell the property within one year after the note's execution, the principal, and interest accruing at a rate of 10% thereon, would become due and payable upon demand by the investor.

In declining health and decreasing confidence in the prospects of the venture, the investor did indeed make such a demand upon the note's final maturity in 2012, but defendant's whereabouts were unknown. At no point, however, did defendant maintain sufficient funds to satisfy Atherton's repayment obligation, either at the outset of the loan or during the period immediately preceding each of the notes' scheduled maturity dates. Criminal prosecution ensued soon thereafter for defendant's failure to disclose "the full facts about whether or not he had the ability to perform his final promise, which is if, at the end of the 12-month period, you're not comfortable where we are,

[1] *People v. Black* (6th App. Dist. 2017) 8 Cal.App.5th 889.

I'll pay you back."[2] Each and every subsequent agreement to extend the prior notes' maturity, therefore, constituted a separate and distinct promissory note (together the "notes"), as well as an additional violation under the Corporate Securities Law.

B. <u>Promissory Notes Deemed not to be "Securities"</u>

The principal issue on appeal involved whether the promissory notes qualified "securities" under the California Corporate Securities Law and thereby as exposed the defendant to criminal liability for making a false statement of material fact in connection with the offering of such security.[3] In making such a determination, California state courts typically apply the "risk capital" test, but may elect instead to apply or incorporate that test formulated by the United States Supreme Court in *SEC v. W.J. Howey Co.* (the "*Howey*" test) – each is meant to provide the court with a flexible framework through which to confront securities fraud in modern markets.[4] To that end, federal and state courts share a common approach in looking to the substance rather than the form of a particular transaction.

Defendant argued for the application of the risk capital test, whereas the prosecution insisted the court apply that test devised in *Howey*. Although similar, the risk capital and *Howey* tests differ in two major respects. First, *Howey* includes as securities only those "investment contracts" made for the purpose of realizing a profit. In contrast, the risk capital test requires only that the investor expect to receive a benefit, which need not even be material (*i.e.* financial gain). Secondly, *Howey* does not require an indiscriminate offering to the public at-large and encompasses all investment contracts, whether or not offered to the public. The court ultimately considered whether the promissory notes qualified as securities under each of the risk capital and *Howey* tests; it did not, however, explain its rationale for reviewing the notes under both standards, but rather referred to the state courts' long withstanding practice of consulting both standards and remarking that "a transaction is a security if it satisfies either test."[5]

Upon review, the court held the notes did not qualify as securities under either of the risk capital or *Howey* tests. Having not been offered to the general public, the notes plainly failed the "indiscriminate public offering" requirement of the risk capital test. Less apparent, though, was the court's justification for declining to find the notes satisfied *Howey*. Indeed, defendant induced the investor to participate in the real estate opportunity he managed by alluding to the potential for substantial financial returns – yet the court found persuasive the superseding policy considerations advanced in *Marine Bank v. Weaver*.[6]

In *Marine Bank*, the United States Supreme Court articulated that when examining whether an instrument falls under the auspices of the federal

[2] *Id*. at 898 n.4

[3] Charging allegations were brought under sections 25401 and 25540 of the California Corporations Code.

[4] According to the risk capital test, a security will be evidenced by some or all of the following: (i) an attempt to raise funds for a business venture through an (ii) indiscriminate offering to the public at-large (iii) in which the investor remains effectively powerless as to the success of the venture and (iv) the venture's business activities are primarily funded by money from people other than the promoter. All four elements need not be present for an instrument to qualify as a security, but rather are assigned different weights according to the facts of each case and considering the "regulatory purpose and purview of the securities laws"; asking in other words, whether the investor placed his or her capital at risk in exchange for receiving some future benefit, which need not be material. (8 Cal.App.5th at 419). A much simpler inquiry is made under the *Howey* test, in that all "investment contracts" evidencing an investment of money in a common enterprise wherein profits are derived solely from the efforts of others qualify as securities.

[5] 8 Cal.App.5th at 412.

[6] 455 U.S. 551 (1982).

securities laws, courts should consider the character given in commerce to the instrument as a result of its terms, plan of distribution, and economic inducements held out to prospective investors.[7] It is through these policy considerations, therefore, the court found the notes' tailored terms removed them from qualifying as securities under *Howey*. Of particular importance to the court's analysis was the absence of any evidence the notes could or were intended to be publicly traded, such as the presence or circulation of a prospectus, and the degree of redress provided by defendant's pledge of certain of his separate property in support of Atherton's absolute obligation to repay.

> In no way did the court intend to suggest or hold that all individually negotiated instruments should be removed as a matter of law from regulation as securities.

C. <u>Regulatory Impact: Dynamic Framework to Define Securities Endures</u>

Issuers and investors alike should heed this case as a blunt, if not perplexing, reminder of the interrelatedness of the federal and state securities regimes. Inadequate due diligence and preparation can expose parties to civil, criminal, and administrative liability in connection with a wholly private and otherwise seemingly exempt transaction. What remains problematic is the judiciary's ongoing refusal to impart specific guidance on when the risk capital and *Howey* tests are to be applied. That is, under what circumstances will California courts elect to apply the *Howey* test over, as an alternative to, or in conjunction with the risk capital test, and vice versa?

This uncertainty can produce seemingly conflicting outcomes not only among and between cases, but also on their appeal. Such inconsistencies abound even within the court's own opinion; such as by its own admission that, "[t]he promissory notes in this case display certain essential characteristics of an 'investment contract' under the *Howey* test," while acknowledging in the immediately following paragraph that the unique terms providing for repayment regardless of whether the deal succeeded, led the trial court judge to conclude that " 'the written language of the contract [essentially] did away with the risk."[8] These conflicts also arose in another case to which the court cites in its opinion, *People v. Schock*.[9] In *Schock*, the trial court found the underlying transaction did not constitute a security under the risk capital test. The appellate court agreed, but reversed on independent grounds, specifically that the instrument qualified as a security under *Howey*. Here too, no explanation was forthcoming as to the court's rationale for finding the instrument to be a security under the *Howey* test notwithstanding its concurrence with the trial court's finding it did not qualify as a security under the risk capital test.

II. CONCLUDING THOUGHTS

As important as the final disposition of this case is the court's refusal to explore the circumstances in which each test should be applied despite recognizing the total absence of precedent on this issue. Musing only that "[w]e remain mindful of our guiding dictate that a transaction must fall within the regulatory purpose of the law," *Black* merely reaffirms the generally recognized position that "federal definitions of securities are also used in California when appropriate in determining whether an investment vehicle is a

[7] Similar to the bespoke nature of the promissory notes in *Black*, *Marine Bank* involved a private agreement which entitled the Weavers to use the Piccirillo's barn and pasture, and receive $100 per month and 50% of the monthly net profits from the family's slaughterhouse, Columbus, in exchange for the Weaver's procurement of a loan and pledge of its proceeds to Marine Bank for the benefit of Columbus.

[8] 8 Cal.App.5th at 409.

[9] (1st App. Dist. 1984) 152 Cal.App.3d 379.

security."[10] No additional guidance or instruction is furnished with regard to when courts may "appropriately" incorporate or perhaps prioritize such federal definitions.

> Even still, a significant contribution of this case rests in the court's holding that "the individualized nature of the transaction is *one factor* that must be considered in determining whether a transaction comes within the regulatory purpose and purview of the securities laws," and, therefore, qualifies as a security under the Corporate Securities Law.[11] Remember again, *Black* does not imply that all individually tailored instruments are excluded from regulation as securities, but rather that the court may appropriately consider such characteristics in its analysis.

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[10] 8 Cal.App.5th at 412 (quoting *People v. Smith* (2nd App. Dist. 1989) 215 Cal.App.3d 230, 237) (internal citations omitted).
[11] *Id*. at 419.