Consider Compliance With Securities Laws
In Your Next Business Law Transaction

Attorneys should always analyze whether a business transaction will result in the issuance of a security. This article will highlight some basic criteria for determining what constitutes a security. A second article will focus on potential exemptions from the registration requirements of the Securities Act of 1933 (the "Securities Act") and the qualification provisions of the California Corporate Securities Law of 1968 (the "California Act").

Attorneys regularly advise and assist their clients in complying with applicable laws in their business transactions. Often Federal and California securities laws apply because the transactions involve the issuance of securities. These securities laws, if applicable, require the attorney to analyze the relevance of California and Federal registration and anti-fraud provisions to the transaction. For example, is there an exemption available for the securities being issued or must they be qualified with the California Department of Corporations under the California Act and/or registered with the Securities and Exchange Commission pursuant to the Securities Act? Do you need to be concerned with the adequacy of disclosures to avoid the potential application of the anti-fraud provisions of Federal securities laws and the California Act?

INVESTMENT CONTRACTS

While there are some minor differences, the basic definition of a "security" under the Securities Act and the California Act is the same. Conventional corporate securities such as stocks and bonds are obvious and, accordingly, are not discussed in this article. Others, such as partnership interests and other forms of profit participations, and promissory notes in various contexts, may be less obvious. Finally, and most importantly, the term "investment contract" serves as a catchall to include any arrangement where a person invests money in a common enterprise with the expectation of realizing a return primarily through the efforts of others (*SEC v. W.J. Howey Co.* [1946] 328 U.S. 293, 298-99). Under the W.J. Howey definition, numerous business transactions involving the sale of such items as real property, personal property, precious metals and gems, and franchises have, under certain circumstances, been deemed to be investment contracts and, thus, securities.

Limited Liability Companies and Partnership Interests as Securities

The interests of limited partners (as opposed to general partners) in a limited partnership, or interests as non-managerial members in a limited liability company, will normally be considered securities. Courts in analyzing these business structures have used the Howey investment contract test and determined these interests to be securities because such interests involve investment in a common enterprise with profits to come solely from the efforts of others.

On the other hand, interests in a general partnership or joint venture normally are not securities because of the legal power of the general partners or venturers to participate in the management and/or business operations of the entity. However, this is not absolute and, accordingly, general partnership or joint venture interests can be determined to be securities, if the partner or joint venture investor can show that the agreement leaves so little power in the hands of the partner or venturer that the arrangement is actually analogous to a limited partnership. In addition, if the partner or venturer lacks sufficient business experience and expertise needed to exercise partnership powers, or the partner or venturer is so dependent on the managerial expertise of other partners or third parties that he cannot exercise substantial partnership or venture power, the investment contract analysis may be used to determine that such interests are securities.

Notes as Securities

A "note" like "stock" and "investment contracts", is specifically included in the definition of a security under the Federal securities laws and the California Act. Nonetheless, under court decisions, notes have not always been deemed to be securities. In *Reeves v. Ernst & Young* (U.S. Sup. Ct. 1990) the Supreme

Court explained that while common stock can be considered to be the "quintessence" of a security, the same cannot be said about notes, which are used in a variety of settings, not all of which involve investments. Accordingly, an approach based on the "economic reality" of the transaction rather than a strict definition of a security under Federal securities laws was utilized. Furthermore, the Court determined that the Howey test for determining whether investment contracts are securities was inappropriate. Instead, the Court utilized the so-called "family resemblance" test that begins with a presumption that a note is a security. That presumption, however, may be rebutted by a showing that the note has a strong resemblance to any of a number of categories of instruments that are not considered securities. These include:

- notes delivered in a consumer financing;
- short-term notes secured by a mortgage on a home;
- short-term notes secured by a lien on a small business or some of its assets;
- notes evidencing a "character" loan to a bank customer;
- short-term notes secured by an assignment of accounts receivable;
- notes which formalize an open-account debt incurred in the ordinary course of business; and
- notes given in connection with loans by commercial banks for current business operations.

The Court then proceeded to establish criteria for determining whether a note bears a "resemblance" to one of the above identified instruments by identifying four factors to be considered. However, it did not explain their relative significance. These factors are:

(1) <u>Motivation for the Transaction</u>. An instrument is more likely to be a security if the seller's purpose is to raise money for general business use or to finance substantial investments and the buyer is primarily motivated by the profit to be realized from the note. For this purpose "profit" means a "valuable return on investment", which includes interest. Conversely, a note is less likely to be considered a security if it is exchanged to facilitate the purchase and sale of a minor asset or consumer good or to advance some other commercial or consumer purpose.

(2) <u>Existence of risk-reducing factor</u>. Does another regulatory scheme exist that significantly reduces the risk of the instrument causing protection under the Federal securities laws to be unnecessary?

(3) <u>Reasonable expectations of the investing public</u>. Instruments will usually be considered securities if the public considers them securities, even if an economic analysis of the circumstances of the particular transaction might suggest a different conclusion.

(4) <u>Plan of distribution of instrument</u>. Will there be common trading for speculation or investment? To establish "common trading" all that is required is that the instruments are offered and sold to a broad segment of the public.

Rejection of Sale of Business Doctrine.

The "sale of a business" doctrine assumed that the definition of an investment contract is generic to all securities (including stock) and that transactions involving, in substance, a sale of a business fail to meet the Howey test of an investment because, among other matters, the purchaser does not expect to realize profits solely through the efforts of third parties

The Supreme Court has rejected this doctrine in two cases, *Landreth Timber Company v. Landreth* (U.S. Sup Ct. 1985) and *Gould v. Ruefenacht* (U.S. Sup. Ct. 1985). In Landreth , the sale of a business through the transfer of 100% of its stock, the Court considered the context of the transaction (i.e., the sale of stock of a corporation) to be one to which the Federal securities laws generally apply, as the stock possessed all the characteristics traditionally associated with common stock. In Gould , the Court held the sale of a business doctrine to be inapplicable in a case involving a purchase of 50% of the stock of a closely-held corporation. Applying the rationale of Landreth , the Court concluded that the sale of stock in

a corporation is typical of the kind of transaction to which the Federal securities laws apply. Thus the stock was considered a security.

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The above discussion is intended to briefly identify some typical business transactions where careful securities law analysis is appropriate. Failure to address these legal considerations can result in serious adverse consequences to a business law client.