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# Licenses--Sales of Stock--Withdrawable Capital Shares [*Tcherepnin V. Knight*, 389 U.S. 332 (1967)]

Charles R. Schaefer

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rights are burdened by the superior rights of the sovereign and may be taken.<sup>44</sup> Yet compensation is required for all substantial takings save only those interests burdened specifically by the navigational servitude.<sup>45</sup> It thus may well be that the premise supporting the no-compensation rule is not on solid footing.

HAROLD R. WEINBERG

LICENSES — SALES OF STOCK — WITHDRAWABLE  
CAPITAL SHARES

*Tcherepnin v. Knight*, 389 U.S. 332 (1967).

The question of what constitutes a security within the Securities Exchange Act of 1934<sup>1</sup> was partially resolved for the first time by the United States Supreme Court in the recent case of *Tcherepnin v. Knight*.<sup>2</sup> In *Tcherepnin*, the petitioners, holders of withdrawable capital shares<sup>3</sup> in the City Savings Association of Chicago, sued City Savings and its officials<sup>4</sup> in the United States District Court for the Northern District of Illinois alleging that: (1) the shares were securities within the definition in the Exchange Act;<sup>5</sup> (2) the shares were purchased because the petitioners had relied on misleading solicitations;<sup>6</sup> (3) and that the misleading solicitations had been mailed in violation of section 10(b) of the Exchange Act<sup>7</sup> and rule 10b-5 of the Securities Exchange Commission (SEC).<sup>8</sup> The petitioners asked that the sales be declared void under section 29(b) of the Exchange Act.<sup>9</sup>

The district court ruled that the shares were securities and denied the respondents' motion to dismiss for lack of jurisdiction. On interlocutory appeal,<sup>10</sup> the Court of Appeals for the Seventh Circuit reversed the district court and held that the shares were not securities within section 3(a)(10) of the Exchange Act.<sup>11</sup>

In reversing the court of appeals the Supreme Court found that the withdrawable capital shares closely resembled an investment contract<sup>12</sup> as construed in *SEC v. W.J. Howey Co.*<sup>13</sup> Although the *Howey* case had actually interpreted the phrase "investment contract" in section 2(1) of the Securities Act of 1933,<sup>14</sup> the Court found no difficulty in applying the *Howey* formula<sup>15</sup> to the Ex-

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<sup>44</sup> *Id.* For a discussion of the rationale see text accompanying notes 1-11 *supra*.

<sup>45</sup> See notes 1-2 *supra* and accompanying text.

change Act.<sup>16</sup> The Court said that the shares represented an investment of money in a common enterprise which depended on the skill of management for success.<sup>17</sup>

Finally, the Court said that the court of appeals had misunderstood the significance of the absence of the term "evidence of indebtedness" which was included in the definition of a security in the Securities Act<sup>18</sup> but omitted from that of the Exchange Act.<sup>19</sup>

<sup>1</sup> 15 U.S.C. § 78 (1964) [hereinafter cited as Exchange Act].

<sup>2</sup> 389 U.S. 332 (1967).

<sup>3</sup> Withdrawable capital shares are one of the two means by which an Illinois savings and loan association may raise capital. ILL. ANN. STAT. ch. 32, § 761 (Smith-Hurd Supp. 1967). Each holder of a withdrawable capital share becomes a member of the association and is entitled to the vote of one share for each \$100 of the aggregate withdrawal value of his account. *Id.* §§ 741(a)(1), 742(d)(2). Holders of the shares receive dividends only from the profits of the association and may voluntarily withdraw the capital only under restricted statutory conditions. *Id.* §§ 778(c), 773. The shares are not negotiable but may be transferred by assignment and delivery. *Id.* § 768.

<sup>4</sup> The officials included the officers and directors of the Association, State officials who had taken custody of the Association, and three liquidators who had been named by the shareholder in a voluntary liquidation plan. 389 U.S. at 333.

<sup>5</sup> Exchange Act § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1964). The pertinent part of the definition reads:

The term "security" means any note, stock, . . . bond, debenture, certificate of interest or participation in any profit-sharing agreement . . . any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security" . . . .

<sup>6</sup> The solicitations portrayed City Savings as a financially strong institution but did not disclose that City Savings was: (1) controlled by a person who had been convicted of mail fraud in connection with a savings and loan association; (2) refused federal insurance because of its unsafe financial policies; (3) previously forced to restrict withdrawals on previously issued shares. 389 U.S. at 334.

<sup>7</sup> 15 U.S.C. § 78j (1964). The section provides that it is unlawful to use any device in the purchase or sale of securities which contravenes the rules and regulations of the Securities Exchange Commission (SEC).

<sup>8</sup> 17 C.F.R. § 240.10b-5 (1967).

<sup>9</sup> 15 U.S.C. § 78cc(b) (1964). This provision declares that every contract made in violation of any sections of the Exchange Act and any rules of the SEC shall be void with regard to the rights of the violator.

<sup>10</sup> 28 U.S.C. § 1292b (1964).

<sup>11</sup> *Tcherepnin v. Knight*, 371 F.2d 374 (7th Cir. 1967).

<sup>12</sup> The investment contract is generally recognized to be a catchall classification for unusual security arrangements. See 1 L. LOSS, SECURITIES REGULATION 483 (2d ed. 1961) [hereinafter cited as LOSS].

<sup>13</sup> 328 U.S. 293 (1946).

<sup>14</sup> 15 U.S.C. § 77b(1) (1964) [hereinafter cited as Securities Act].

<sup>15</sup> See note 25 *infra* & accompanying text.

<sup>16</sup> This is not unusual. See, e.g., SEC v. Los Angeles Trust Deed & Mortgage Exch., 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961).

<sup>17</sup> 389 U.S. at 338-39.

<sup>18</sup> 15 U.S.C. § 77b(1) (1964).

<sup>19</sup> Compare *id.*, with Exchange Act § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1964).

While the omission might be significant in other cases, it is not significant in *Tcherepnin* because the holder of the withdrawable capital shares can never become a creditor.<sup>20</sup> Therefore, the certificate can never be considered evidence of indebtedness.<sup>21</sup>

The two leading cases<sup>22</sup> which have construed the definition of a security under federal legislation are *SEC v. C.M. Joiner Leasing Corp.*,<sup>23</sup> and *SEC v. W.J. Howey Co.*<sup>24</sup> In *Joiner*, the Court gave an extremely general test for what constitutes a "security" placing emphasis on the nature and extent of the *risk* to the initial investment.<sup>25</sup> In *Howey*, however, the Court defined "investment contract" as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to *expect profits* solely from the efforts of the promoter or a third party . . ."<sup>26</sup> Thus, the *Howey* approach to definition of a "security" represents a shift in emphasis from investment risk to profit expectation,<sup>27</sup> and since risk is not necessarily a function of profit expectation,<sup>28</sup> *Howey* operates as a narrowing clarification of the *Joiner* test.<sup>29</sup>

*Tcherepnin* professes to adhere to both the *Joiner* and *Howey* decisions, however, the Court's reasoning indicates that it may have lost contact with the concept of a security. While there is an indication<sup>30</sup> that the Court may be reemphasizing the *Joiner* focus on

<sup>20</sup> See ILL. ANN. STAT. ch. 32, § 773 (f) (Smith-Hurd Supp. 1967).

<sup>21</sup> The negative implication of the Court's conclusion is that if the certificate could be an evidence of indebtedness, it may not be a security under the Exchange Act. For a discussion of the validity of this implication, see text accompanying note 48 *infra*.

<sup>22</sup> Both cases concern arrangements which are characterized by the catchall category of investment contracts.

<sup>23</sup> 320 U.S. 344 (1943).

<sup>24</sup> 328 U.S. 293 (1946).

<sup>25</sup> The existence of a security was to be determined by the character of the instrument in commerce, the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. 320 U.S. at 352-53; see Coffey, *The Economic Realities of "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367, 381 (1967). See also 1 LOSS *supra* note 12, at 481-82.

<sup>26</sup> 328 U.S. at 298-99 (emphasis added).

<sup>27</sup> See Coffey, *supra* note 25, at 381.

<sup>28</sup> See notes 39-41 *infra* & accompanying text.

<sup>29</sup> See Pasquesi, *The Expanding "Securities" Concept*, 49 ILL. B.J. 728, 730 (1961).

<sup>30</sup> The inference is the author's reaction after observing the Court's express adoption of much of the reasoning of the dissenting opinion in the court of appeals which emphasized the risk to initial investment:

If the association is successful, the investors' holdings are worth more than the price paid. If, as here, the association is unsuccessful, the shares become worth very little. It is the fluctuation in the value of their shares that is important to the shareholders . . . [T]he use of the federal anti-fraud provisions would help to guard against circumstances that would plummet the

the risk to initial investment,<sup>31</sup> the Court is forgetting the *Joiner* rule concerning the interpretation of securities legislation<sup>32</sup> when it says that "[i]n addition, we are guided by the familiar *canon* of statutory construction that remedial legislation should be construed broadly . . . ."<sup>33</sup> If this canon is true, it follows that criminal legislation must be strictly construed. Since the Exchange Act provides criminal penalties for its violation,<sup>34</sup> the existence of a security could depend as much on the type of action as on the statutory requirements.<sup>35</sup>

The Court not only strayed from *Joiner's* clear principles of statutory interpretation, but also clouded *Howey's* concept of profit inducement. Although the Court seems correct in saying that the existence of the relationship between investor profits and income statement profits of the risk enterprise satisfies the *Howey* formula,<sup>36</sup> it is unnecessary for the Court to imply<sup>37</sup> that *Howey* requires such a relationship.<sup>38</sup> Profits to an investor can be completely separate and unrelated to the accounting profits of the enterprise.<sup>39</sup> Fixed interest payments on a debt obligation,<sup>40</sup> appreciation in the value

share value downwards. *Tcherepnin v. Knight*, 371 F.2d 374, 384 (7th Cir. 1967) (dissenting opinion).

<sup>31</sup> Some recent federal and State decisions have recognized this risk as an essential element. In *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966), the court said that "[t]he effect on an investor of an issuer corporation's failure to disclose . . . [creates] an appreciable risk of loss to that investor . . ." *Id.* at 680. See also *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961), discussed in Coffey, *supra* note 25, at 391 nn.106 & 402. See generally Sobieski, *Securities Regulation in California: Recent Developments*, 11 U.C.L.A.L. REV. 1, 5-7 (1963).

<sup>32</sup> *Joiner* established that the canonized arguments of *ejusdem generis* and *expressio unius* did not aid the interpretation of securities legislation which should be construed by discovering the purposes of the legislation and interpreting the provisions in light of those purposes. 320 U.S. at 350. See Coffey, *supra* note 25, at 405-06.

<sup>33</sup> 389 U.S. at 336 (emphasis added).

<sup>34</sup> 15 U.S.C. § 78ff(a) (1964).

<sup>35</sup> The Court's language is so vague and unclear that it is conceivable that lower courts might treat it as demanding differing tests for determining if a security exists depending on whether the nature of an action is civil or criminal. That this result could derive from the "legislative intent" seems somewhat ludicrous.

<sup>36</sup> 389 U.S. at 338-39.

<sup>37</sup> The length of the Court's discussion and the reemphasis of the relationship make it appear that the relationship is vital to the existence of a security. *Id.*

<sup>38</sup> Clearly *Howey* does not require such a relationship. See Coffey, *supra* note 25, at 403.

<sup>39</sup> *Id.* at 401-02.

<sup>40</sup> This is the usual arrangement on corporate bonds where interest must be paid whether or not the corporation has earned a profit. P. SAMUELSON, *ECONOMICS — AN INTRODUCTORY ANALYSIS* 87 (6th ed. 1964). See also A. FREY, C. MORRIS & J. CHOPER, *CASES AND MATERIALS ON CORPORATIONS* 1256 (1966).

of a security, and nonpecuniary benefits in excess of the investment<sup>41</sup> are as much profits under *Howey* as dividend distributions from an enterprise's net income.<sup>42</sup> The danger in emphasizing the relationship is that some lower courts may consider it a prerequisite in determining the existence of a security.<sup>43</sup>

Perhaps the most disturbing aspect of the *Tcherepnin* opinion is the Court's repeated comparisons of the capital shares with equity share interests in a risk enterprise.<sup>44</sup> The disturbance culminates with the Court's statement that the omission of evidence of indebtedness from the Exchange Act<sup>45</sup> is not significant in *Tcherepnin* because the shareholders never become creditors of the savings and loan.<sup>46</sup> The negative implication of this conclusion is that if the shareholders were creditors, the shares might not have been securities.<sup>47</sup> However, even if the shareholders were creditors, the economic realities of a security would be present because buyers, unfamiliar with the operations of the enterprise and induced by a seller's representations which aroused reasonable expectations of profits, furnished the seller with investments which were subjected

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<sup>41</sup> An example is the purchase of an entrance privilege to a club which is acquired before the club's completion when the value of the entrance privilege (club membership) is less than it will be on the completion of the club facilities. See Coffey, *supra* note 25, at 402-03.

<sup>42</sup> *Id.* at 377-78.

<sup>43</sup> If some courts interpret the relationship as a necessary element of a security, investors might be deprived of the anti-fraud protection of securities legislation. Such a result would be strange in light of the continuing drive to expand the security concept for the purposes of the anti-fraud provisions. See generally Pasquesi, *supra* note 29.

<sup>44</sup> *E.g.*, . . . "[p]etitioners' shares can be viewed as certificate[s] of interest or participation in [a] profit-sharing agreement. [They] must be evidenced by a certificate . . . [D]ividends are contingent upon an apportionment of profits. These . . . factors make the shares 'stock' under § 3(a)(10)." 389 U.S. at 339. Later, in discussing the court of appeals' disposition of the fact that the shareholders were not entitled to inspect the general books of the association, the Court said, "Inspection of that nature . . . is not a right which universally attaches to corporate shares." *Id.* at 344.

<sup>45</sup> The SEC takes the position that the inclusion of the phrase in the Securities Act and the exclusion from the Exchange Act is merely a difference in draftsmanship and is therefore of little significance. *Tcherepnin v. Knight*, 371 F.2d 374, 377 (1967). See generally K. DAVIS, ADMINISTRATIVE LAW 78-79 (1959) concerning the binding effect of administrative interpretations.

<sup>46</sup> 389 U.S. at 344.

<sup>47</sup> Such a result would be absurd in light of the policy of emphasizing economic reality. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946). Moreover, the statutory definition on its face contains many debtor-creditor relationships such as parties to a note, bond, or debenture transaction. See Exchange Act § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1964). Cases under the Securities Act have also held debtor-creditor relationships to be securities. See, e.g., *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954) (sale of promissory notes); *SEC v. Vanco, Inc.*, 166 F. Supp. 422 (D.N.J. 1958) (sale of renewable promissory notes). See also cases cited in Coffey, *supra* note 25, at 385 n.85.

to the risks of an enterprise in exchange for debt-holders claims.<sup>48</sup> Therefore, it is irrelevant that the shares resembled equity interests and the Court's emphasis on the resemblance is misleading.

It can only be hoped that the implications of *Tcherepnin's* loose terminology are not the beginning of a trend toward restricting the definition of a security to include only instruments which are specifically designated in the statutes or which possess many equity characteristics.<sup>49</sup> Despite the loose language, *Tcherepnin* did dispel any doubt concerning the applicability of the fraud sections of securities legislation<sup>50</sup> to savings and loan securities<sup>51</sup> merely because they are exempt from registration.<sup>52</sup> It seems possible that the future might see many savings and loan accounts (whether evidenced by certificates, shares, or passbooks) regulated, for fraud purposes, under securities legislation if they meet the risk<sup>53</sup> and profit inducement

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<sup>48</sup> See Coffey, *supra* note 25, at 377.

<sup>49</sup> The equity characteristics present in *Tcherepnin* were voting control, percentage sharing in profits, and profits to the investor to be paid only from enterprise earnings.

<sup>50</sup> Securities Act §§ 12(2), 17(a), 15 U.S.C. §§ 771(2), 77q(a) (1964); Exchange Act §§ 10(b), 15(c) (1), 15 U.S.C. §§ 78j(b), 78o(c) (1).

<sup>51</sup> It seemed impossible that anyone could think that savings and loans were exempt from the fraud sections by virtue of the exemption from registration until the Seventh Circuit decision. See II LOSS 798. Even savings and loan executives intended to adhere to the anti-fraud sections. Morton Bodfish, Executive Manager of the United States Building and Loan League, said that "we are in accord with [the] section[s] . . . which would apply to all of our associations if there are any improper or fraudulent or deceptive practices." *Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 70, 72 (1933). Other league officials held similar opinions concerning the regulation of savings and loan securities. See *Hearings on S. 875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 50, 51 (1933).

<sup>52</sup> The exemptions are found in both the Securities Act and the Exchange Act. Securities Act § 3(a) (5), 15 U.S.C. § 77c(a) (5) (1964); Exchange Act § 12(g) (2) (C), 15 U.S.C. § 781(g) (2) (C) (1964). The requirements which must be met in order to qualify for the exemptions have been the subject of some litigation. See, e.g., *SEC v. America Int'l Sav. & Loan Ass'n*, 199 F. Supp. 341 (D. Md. 1961); *American Fin. Co.*, 40 S.E.C. 1043 (1962).

<sup>53</sup> An argument can be made that savings and loan accounts insured by the United States Government are subject to little if any risk. Therefore, insured accounts, lacking the essential risk element, would not be securities. However, to the extent that the amount deposited exceeds the insurable limit, an account may be considered a security. The Supreme Court has previously separated seemingly unified instruments and held that one part is a security and another part is not. See *SEC v. United Life Benefit Ins. Co.*, 387 U.S. 202 (1967), which concerned an annuity plan part of which was the traditional fixed annuity and part of which was a variable annuity. The former was held not a security and the latter was held to be a security. See also *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959), which concerns the applicability of securities regulation to variable annuities. Moreover, the Federal Savings and Loan Association Act, 12 U.S.C. § 1464(a) (1964) emphasizes the investment character of share accounts and distinguishes them from a debtor-creditor relationship. See *Wisconsin Bankers Ass'n v. Robertson*, 294 F.2d 714, 717-18 (D.C. Cir. 1961) (concurring opinion).

requirements of a security. In addition, other bank savings plans<sup>54</sup> (as opposed to savings and loan share accounts) which purport to be debtor-creditor relationships<sup>55</sup> may also be subject to securities regulation.

If the purpose of securities regulation is really to protect the uninitiated investor from the abuses of misrepresentation,<sup>56</sup> there is no policy reason for exempting the securities of banks, savings and loan associations, and similar institutions from the anti-fraud provisions of securities legislation. Compliance with the provisions would not involve excessive burdens on the institutions<sup>57</sup> and would protect the typical unsophisticated investor who places his savings in these institutions. In any case, the securities should be exempted only by legislative fiat and not by a judicial contraction of the definition of a security.

CHARLES R. SCHAEFER

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<sup>54</sup> Depending upon one's point of view, a savings and loan share account is either very similar to or very different from other types of accounts such as commercial bank savings accounts and mutual bank savings accounts (nonshareholder type). Compare Prather, *Savings Accounts in Savings and Loan Associations*, 15 BUS. LAW. 44 (1959), which emphasizes the similarities, with, Brunner, *Status of Mutual Savings Bank Depositors as Contrasted with Savings and Loan Shareholders*, 14 BUS. LAW. 1047 (1959), which emphasizes the differences between the debtor-creditor and shareholder relationships.

<sup>55</sup> But the mere fact that there is a debtor-creditor relationship does not remove the existence of the economic realities of a security. See text accompanying notes 47-49 *supra*. Savings accounts in national banks may fall into this category. To the extent they are uninsured, they may also be securities. The relevance of insurance is discussed in note 53 *supra*. Moreover, the exemption from registration for national bank securities under the Securities Act § 3(a)(10), 15 U.S.C. § 77c(a)(2) (1964) would be as unavailable to these institutions as it was to the savings and loan association in *Tcherepnin*.

<sup>56</sup> See Note, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1120-21 (1950). See also *Zatz v. Hertz, Neumark & Warner*, 262 F. Supp. 928, 930-31 (S.D.N.Y. 1966); White, *From the Frying Pan Into the Fire: Swindlers and the Securities Acts*, 45 A.B.A.J. 129, 131 (1959), where the author discusses the use of the tort concept when a statute designed to protect a particular class of individuals (apparently the uninitiated investor) is violated.

<sup>57</sup> *Tcherepnin v. Knight*, 371 F.2d 374, 384 (7th Cir. 1967) (dissenting opinion).