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Cover Page Footnote

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SOMETIMES PROMISING IS NOT SO PROMISING: THE BREAKDOWN OF THE FAMILY RESEMBLANCE TEST

Cori R. Haper[*]

I. INTRODUCTION

"Unpredictable," "confusing," "jumbled," "haphazard."[1] Unfortunately, this is still the state of the family resemblance test more than twelve years after the Supreme Court's articulation of the test in *Reves v. Ernst & Young*.[2] Despite the Supreme Court's attempt to clarify the issue of when a "note"[3] is a "security"[4] under the Securities Acts of 1933 and 1934 with its formulation of the family resemblance test, the Court's articulation of the test in *Reves* left securities law in a state of uncertainty.

The Securities Acts of 1933 and 1934 ("Securities Acts") regulate the issuance and sale of securities.[5] Both Securities Acts define the term "security" by listing items that are securities.[6] If an instrument or transaction meets the definition of "security," then under the Securities Act of 1933, the issuer must register its initial sale unless an exemption from

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[1] Lawrence Page, *Even After* Reves, *Securities Do Not Have Families: Returning to Economic and Legal Realities Through a Connotative Definition of a Security*, 1992 U. Ill. L. Rev. 249, 288, 300 (1992).

[2] 494 U.S. 56 (1990).

[3] *Note* is defined as "[a] written promise by one party to pay money to another party or to bearer." *Black's Law Dictionary* 1085 (Bryan A. Garner ed., 7th ed., West 1999).

[4] *Infra* n. 6.

[5] *Reves*, 494 U.S. at 60-61. "The Securities Act of 1933 and Securities Exchange Act of 1934 are two of the most important pieces of federal securities legislation." Robert M. Simmons, *When Are Notes Securities?: Adding Certainty to the Process of Defining a Security Under the Federal Securities Laws*, 22 U. Toledo L. Rev. 1119, 1120 (1991). The 1933 Act regulates the initial public offering or distribution of securities. *Id.* The 1934 Act applies primarily to secondary sales – trading in securities already issued and outstanding. *Id.*

[6] 15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (2000). The term "security" means:

> any note, stock, treasury stock, security future, 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 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.

Id. at § 77b(a)(1).

registration applies.[7] "Notes" are included in the definition of "security."[8] The purpose of the Securities Acts, however, was to regulate investments, not to regulate all notes.[9] Thus, only notes that are issued as investments are regulated by the Securities Acts.[10]

Courts have recognized that not all notes are issued for investment purposes.[11] Many notes are used in ordinary business transactions. If a note is issued in everyday business transactions such as accounts payables, it is not a security.[12] To further explain, if a business that is borrowing money issues a note for the purpose of generating capital for the business, and the buyer is receiving a high interest rate on the note, the note is likely issued for investment purposes because both the buyer and the seller expect to make a significant gain on the transaction based on the business's growth. On the other hand, if a business issues a note to obtain a loan so that it can pay its day-to-day expenses, or an individual issues a note so that it can purchase a consumer good such as a car, television, or mortgage, the note is likely not a security because it advances a basic operating purpose, rather than an investment purpose, and the buyer of the note is likely earning just the going interest rate. The question becomes how to distinguish between notes issued for ordinary commercial purposes and notes issued for investment purposes.[13]

The *Reves* Court set forth the family resemblance test as a means to determine which notes are securities.[14] This test resolved several circuit splits disputing the appropriate test to use: the risk capital test,[15] the

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[7] *Id.* at §§ 77e, 77f. Registration involves amassing information concerning the issuer's operations including: (1) a thorough factual investigation of all aspects of the business; (2) document reviews; (3) thorough analysis of the company's business structure; (4) survey of the physical plant; (5) study of contracts and business agreements; (6) a thorough investigation of the issuer's management structure; (7) a study of the issuer's research and development activities; (8) a compilation of operating statistics including relevant trends and ratios; and (9) a thorough understanding of the issuer's financial relationships. Thomas Lee Hazen, *The Law of Securities Regulation*, 123-124 (4th ed., West 2002).

[8] 15 U.S.C. § 77b(a)(1).

[9] Sen. Rpt. 73-47 at 1 (Apr. 27, 1933); *see* Park McGinty, *What is a Security*, 1993 Wis. L. Rev. 1033, 1087 (1993) ("Sweeping into coverage arrangements that are not investments transgresses the legislative purpose of the securities laws . . . to protect all investments but not to interfere in arrangements that are not investments"). *Investment* is defined as "[a]n expenditure to acquire property or assets to produce revenue." *Black's Law Dictionary* at 831.

[10] *Reves*, 494 U.S. at 61.

[11] *Id.* at 62.

[12] *Id.*

[13] If a note is issued for commercial purposes, it is not a security and the issuer need not comply with the regulations contained in the Securities Acts. If a note is issued for investment purposes, it is a security and regulated by the Securities Acts. *Id.*

[14] *Infra* nn. 24-27 and accompanying text (describing the family resemblance test).

[15] *Infra* nn. 68-75 and accompanying text (describing the risk capital test).

commercial/investment test,[16] the *Howey* test,[17] and the Second Circuit's family resemblance test.[18] When the issue reached the Supreme Court in *Reves*, Justice Marshall chose to adopt the family resemblance test after explicitly rejecting the *Howey* test.[19] He acknowledged that the commercial/investment test and the family resemblance test are really two similar means by which to determine the issue of whether a note is a security, but felt that the family resemblance test had "a more promising framework for analysis."[20]

Unfortunately, the framework of the family resemblance test has proven to be anything but promising to lower courts applying the test over the past twelve years. The family resemblance test is unclear.[21] The framework does not provide courts clear guidance to interpret and apply the test. Moreover, it is restrictive in its application. As lower courts have struggled to apply the test over the past twelve years, their actual interpretations and applications have resulted in a breakdown of the structure of the family resemblance test.

Under the family resemblance test, notes are presumed to be securities because "notes" are listed in the definition of "security" itself,[22] but not all notes are securities. To begin, the family resemblance test provides an enumerated list of notes that are clearly non-securities.[23] If a particular note bears a "family resemblance" to a note on the enumerated list, then it too is

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[16] *Infra* nn. 54-66 and accompanying text (describing the commercial/investment test).

[17] *Infra* nn. 76-81 and accompanying text (describing the *Howey* test).

[18] *Infra* nn. 82-90 and accompanying text (describing the Second Circuit family resemblance test).

[19] The Court implicitly rejected the risk-capital test as well, concluding that it was an approach "that is virtually identical to the *Howey* test" which it explicitly rejected. *Reves*, 494 U.S. at 64.

[20] *Id.* at 64-65.

[21] John C. Cody, *The Dysfunctional "Family Resemblance" Test: After Reves v. Ernst & Young, When Are Mortgage Notes "Securities"?*, 42 Buff. L. Rev. 761, 826 (1994) (predicting that "courts probably will determine for other reasons what the outcomes should be, and then the various factors relating to the buyers' state of mind will be recited appropriately in a manner consistent with the result reached").

[22] 15 U.S.C. § 77b(a)(1); *Reves*, 494 U.S. at 60.

[23] The Second Circuit developed the list of enumerated notes, and the *Reves* Court adopted the list as part of its version of the family resemblance test. *Exch. Natl. Bank of Chi. v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976).

The notes on this list include notes delivered in consumer financing, 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 formalizing an open-account debt incurred in the ordinary course of business, and notes evidencing loans by commercial banks for current operations. *Reves*, 494 U.S. at 65. However, the *Reves* Court noted that the Second Circuit failed to explain what made these notes non-securities. *Id.* at 65-66.

deemed a non-security.[24]

To determine if a note bears a family resemblance to a note on the list, the family resemblance test provides four factors for courts to consider.[25] These factors include: (1) the motivations of the buyer and seller; (2) the plan of distribution of the note; (3) the reasonable expectations of the investing public; and (4) whether some factor reduces the risk of the instrument.[26] If, after considering these four factors, a court determines that the note does not bear a family resemblance to the notes on the enumerated list, it should apply the four factors a second time to determine if a new category of note should be added to the enumerated list of non-securities.[27]

The family resemblance test has raised several questions for courts applying the test. First, courts puzzle over how applying the four factors a second time will yield a result different from that obtained after applying them the first time. Second, courts are unsure how to apply the factors. Third, the four factors themselves require the courts to engage in a restrictive analysis due to the limited scope of just four factors.

As courts have struggled to apply the family resemblance test over the past twelve years, the framework of the test has broken down to the point that the Supreme Court should start over with a more familiar and flexible test that will achieve the same regulatory result in identifying investment securities. Section II of this Comment outlines the text, purpose, and background of the 1933 and 1934 Securities Acts; the tests that courts used to determine whether a note was a security before *Reves*; and post-*Reves* commentary's predictions of the test's failure. Section III describes the questions raised by the Court's articulation of the test, describes the various interpretations federal courts have given the test during the past twelve years, and argues that the limited scope of the four factors requires courts to engage in a restrictive analysis. This Comment will suggest that the Court should have adopted the Second Circuit's list of enumerated non-security notes and coupled it with the commercial/investment test's flexibility and use of non-restrictive factors for courts to apply should the note not fall squarely into the enumerated list of non-security notes. This will revive the promise that the Supreme Court once saw in the family resemblance test.

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[24] If a particular note shares the non-security characteristics of the notes on the enumerated list, it bears a family resemblance to the notes on the list and is deemed part of that family. *Id.* Thus, the more closely any particular note resembles any of the categories of notes on the enumerated list, the more likely it is that the securities laws do not apply. Hazen, *supra* n. 7, at 105.

[25] *Reves*, 494 U.S. at 65-66.

[26] *Id.* at 66-67.

[27] *Id.* at 67. This Comment focuses upon the second application of the four factors as the source of much of the courts' confusion in applying the family resemblance test.

II. BACKGROUND

A. *Background and Purpose of the Securities Acts of 1933 and 1934*

1. History of the Securities Acts

During the early days of widespread securities investment – starting in the mid-1800s and culminating in the stock market crash of 1929 – the largely unregulated securities market was weakened by fraud and abuse.[28] Individuals were persuaded to invest their money in highly speculative, fraudulent transactions without adequate information on which to make informed decisions.[29] Injured by this fraud, investors lost confidence in the securities market.[30] In response, the government began to enact legislation designed to regulate the securities market and restore investor faith.[31] Although the states attempted to enforce their own securities regulation laws, their limited resources rendered these attempts ineffective.[32]

Thus, Congress adopted a scheme of disclosure and antifraud requirements that requires issuers of securities to disclose material information about the securities they offer.[33] The purpose of the disclosure requirement is to allow investors to make well-informed decisions about the risks and merits of the investment.[34] This disclosure requirement is supplemented by an antifraud provision that penalizes issuers who fail to provide all material information that investors need to make their investment decisions.[35] Thus, the policy of the federal securities laws still is to promote investor faith that the securities offered to the public are legitimate and to assure investors "that fraud will not strip [them] of their expected profits."[36]

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[28] Page, *supra* n. 1, at 255-256.

[29] *Id.* at 256.

[30] *Id.*

[31] *Id.* at 255. Both of the Securities Acts "are remedial statutes designed to protect *investors* from fraud, misrepresentation, market manipulation, and other harmful activities." Simmons, *supra* n. 5, at 1120 (emphasis in original).

[32] Page, *supra* n. 1, at 256.

[33] H.R. Conf. Rpt. 73-152 at 1 (May 20, 1933).

[34] 15 U.S.C. § 77e; Hazen, *supra* n. 7, at 27-28.

[35] 15 U.S.C. § 78j(b); Page, *supra* n. 1, at 258.

[36] Page, *supra* n. 1, at 255, 259-260.

2. Investments as Securities

The federal securities laws only regulate securities.[37] In general, securities are investments.[38] Thus, Congress's purpose in enacting the securities laws was to regulate investments.[39] In both the 1933 and 1934 Securities Acts, Congress broadly defined the term "security" by identifying items that are considered investments. The term "security" means:

> any *note*, *stock*, treasury stock, security future, 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 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.[40]

Congress enacted a definition of "security" that was broad enough to cover virtually any instrument that might be sold as an investment.[41] Indeed, Congress:

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[37] Hazen, *supra* n. 7, at 62. Thus, in order to establish a violation of the securities laws, a plaintiff must first establish that a security is involved. *Id.* at 61-62.

[38] *SEC v. W. J. Howey Co.*, 328 U.S. 293, 297 (1946) (noting that the 1933 Securities Act defines the term "security" to "include the commonly known documents traded for speculation or investment").

[39] Sen. Rpt. 73-47at 1; *Reves*, 494 U.S. at 61.

[40] 15 U.S.C. § 77b(a)(1) (emphasis added to items that will be discussed further in this Comment). The Supreme Court has held that the definitions of "security" in the 1933 and 1934 Securities Acts are virtually identical and for purposes of determining whether a note is a security, the coverage of the two Acts may be considered the same. *Reves*, 494 U.S. at 61 (citing *United Housing Found. v. Forman*, 421 U.S. 837, 847 n. 12 (1975)).

[41] *Reves*, 494 U.S. at 61. Consequently, all of the following have been held to be securities within the meaning of the federal securities statutes: "scotch whiskey, self-improvement courses, cosmetics, earthworms, beavers, muskrats, rabbits, chinchillas, animal feeding programs, cattle embryos, fishing boats, vacuum cleaners, cemetery lots, coin operated telephones, master recording contracts, pooled litigation funds, and fruit trees." Hazen, *supra* n. 7, at 37-38.

Instrument means a "written legal document that defines rights, duties, entitlements, or liabilities, such as a contract, will, promissory note, or share certificate." *Black's Law Dictionary* at 801.

> recognized the virtually limitless scope of human ingenuity, especially in the creation of "countless and variable schemes devised by those who seek the use of money of others on the promise of profits," and determined that the best way to achieve its goal of protecting investors was to define "the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."[42]

Thus, "Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called."[43]

Furthermore, courts do not limit the scope of the securities laws to only transactions identified by terms on the list but disregard the form and title of the transaction, looking at the substance of the transaction to determine if in reality it is an investment included in the definition of "security."[44] This approach draws into the purview of the securities laws those issuers of securities seeking to evade the coverage of the Securities Acts by calling their transactions by a name not included in the definition of "security."[45]

Some financial transactions, if called by names included in the definition of "security" and having the characteristics of that name, are unquestionably securities. For example, in *Landreth Timber Co. v. Landreth*,[46] the Supreme Court recognized that "stock," which is listed in

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[42] *Reves*, 494 U.S. at 60-61 (internal citations omitted); *see also Forman*, 421 U.S. at 847-848 (quoting H.R. Rep. No. 85, 73d Cong. 1st Sess., 11 (1933)).

[43] *Reves*, 494 U.S. at 61 (emphasis in original).

[44] *Id.* Rather than relying on the issuer to accurately label its transaction as "stock" if it were "stock" or "investment notes" if it were "investment notes," the courts peeled away the outside form of the transaction to determine if an investment was involved. This is an application of the economic-realities test: "A method by which a court determines the true nature of a business transaction or situation by examining the totality of the commercial circumstances." *Black's Law Dictionary* at 531. Furthermore, "[b]ecause securities transactions are economic in character, Congress intended the application of [the Securities Acts] to turn on the economic realities underlying a transaction, and not on the name appended thereto." *Forman*, 421 U.S. at 849.

[45] For example, in *SEC v. W. J. Howey Co.*, Howey Company sold parcels of orange groves on land sales contracts, along with servicing contracts, wherein an affiliated service company cultivated and harvested the groves of oranges, marketed the crops for sale, and gave the profits from the sale of oranges to the participants in the sale. 328 U.S. at 295. Although Howey did not characterize this transaction as selling securities, the Supreme Court found that because the purchasers were investing money in a common enterprise, expecting profits, solely from the efforts of the service company, the transaction qualified as an investment contract security. *Id.* at 298-299.

On the other hand, in *Forman*, despite the fact that the seller's sale of ownership interests in a condominium cooperative was called "stock," the Supreme Court found that based on the economic realities of the transaction, the ownership interests, although called "stock," were not securities because the stock did not have the characteristics of stock. 421 U.S. at 851.

[46] 471 U.S. 681 (1985).

the definition of "security," is always an investment if it has the economic characteristics traditionally associated with stock.[47] If investors are buying stock, they justifiably assume that the sale of stock is covered by the Securities Acts' protections.[48]

On the other hand, some financial transactions that are included in the definition of "security" are not necessarily securities.[49] In order for these transactions to be securities, the economic realities of the transaction must show that the item listed in the definition of "security" was issued as an investment.[50] Notes are one such example.[51] Unlike stock, not all notes having the characteristics of notes are securities. The Supreme Court has recognized that "note" is a broad term that encompasses instruments issued both in the commercial context and the investment context.[52] Because the Securities Acts regulate investments, only those notes that are issued in an investment context are covered by the Acts. Thus, merely because a note has the characteristics of a note does not necessarily mean that it is covered by the Securities Acts. Rather, only those notes issued as investments are regulated by the securities laws. Because notes are listed in the definition of "security," however, they are presumed to be securities unless the issuer can rebut the presumption by demonstrating that the circumstances of the transaction indicate that they were not issued as investments.[53]

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[47] *Id.* at 686.

[48] *Id.* However, if stock does not have the economic characteristics traditionally associated with stock, then just because it is called "stock" does not mean that it is necessarily a security. For example, in *Forman*, despite the fact that the seller's sale of ownership interests in a condominium cooperative was called "stock," the Supreme Court found that based on the economic realities of the transaction the ownership interests, although called "stock," were not securities because the stock did not have the characteristics of stock. 421 U.S. at 851.

[49] Whereas a sale of stock is always a sale of a security if the transaction has the characteristics of stock, and is thus, a per se security, a sale of a note is not a sale of a security unless the circumstances of the transaction first demonstrate that the issuer sold the note as an investment. *Reves*, 494 U.S. at 62-63.

[50] *Supra* n. 44 (defining "economic-realities test").

[51] However, bonds and debentures are individually listed items in the definition of "security." Although they are notes, they are per se securities. 15 U.S.C. § 77b(a).

[52] *Reves*, 494 U.S. at 62. One writer explained the difference as follows: "A public offering of instruments that are denominated 'notes' but might just as well be called 'debentures' or 'bonds' is clearly an offer of a 'security.'" However, "[j]ust as clearly, the personal note given as a down payment on a television set is *not* a 'security.'" Louis Loss & Joel Seligman, *Securities Regulation* vol. 2, 934 (3d ed., Aspen 1999) (emphasis in original).

[53] *Reves*, 494 U.S. at 65. Circumstances that suggest that a note is not an investment are determined by application of one of several tests. Prior to the *Reves* decision that adopted the family resemblance test, circuit courts applied the risk capital test, the commercial/investment test, the *Howey* test, and the family resemblance test. *Id.* at 63-64.

B. *Circuit Court Tests Used to Determine Whether a "Note" is a "Security" Before* Reves v. Ernst & Young

Before the *Reves* decision, the lower federal courts applied several tests to determine whether a note in question was issued for investment purposes, and thus regulated by the disclosure and antifraud provisions of the Securities Acts: (1) the commercial/investment test; (2) the risk capital test; (3) the *Howey* test; and (4) the Second Circuit family resemblance test.

1. Commercial/Investment Test[54]

Before *Reves*, a majority of the federal courts used the commercial/investment test to determine if a note was a security.[55] The commercial/investment test distinguishes notes issued in the investment context from notes issued in the commercial context by using all of the circumstances surrounding the transaction.[56] If a note is issued as an investment, it is a security. But if a note is issued in a commercial transaction, it is not a security.[57] This test is premised on the view that Congress, in enacting the securities laws, was concerned with "practices associated with investment transactions and that the securities laws were not designed to regulate commercial transactions."[58]

Courts applied this test on a case-by-case basis.[59] Although courts delineated a number of factors to determine if a particular note was part of an investment transaction or commercial transaction, evaluation of each factor was not necessary and the list of factors could expand to meet the

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[54] The First, Third, Fifth, Seventh, and Tenth Circuits followed this test. *See Futura Dev. Corp. v. Centex Corp.*, 761 F.2d 33, 40 (1st Cir. 1985) (declaring that the commercial/investment test is most effective in assessing the need for disclosure under the facts of a transaction); *Lino v. City Investing Co.*, 487 F.2d 689, 694 (3d Cir. 1973) (holding that the commercial context of the case required a finding that the promissory notes were not securities); *McClure v. First Natl. Bank of Lubbock, Tex.*, 497 F.2d 490, 495 (5th Cir. 1974) (stating that the investment or commercial nature of a note entirely controls the applicability of the Securities Acts); *Hunssinger v. Rockford Bus. Credits, Inc.*, 745 F.2d 484, 488 (7th Cir. 1984) (noting that the Seventh Circuit used the commercial/investment test); *Zabriskie v. Lewis*, 507 F.2d 546, 552 (10th Cir. 1974) (reasoning that "[n]otes issued for personal loans and consumer installment purchases are not securities. Notes that are issued for investments and business acquisitions . . . are securities.").

[55] *Id.*

[56] *Reves*, 494 U.S. at 63.

[57] *Id.*

[58] Loss & Seligman, *supra* n. 52, at 936.

[59] *Id.* at 937.

facts of each case.[60] For example, in *McClure*, an early case applying the commercial/investment test, the court identified three factors that shed light on whether the promissory note at issue was an investment: (1) whether the note was offered to some class of investors; (2) whether the note was acquired by the investor for speculation or investment; and (3) whether the note was offered in exchange for investment assets (i.e. long-term capital), rather than merely to pay off a business debt.[61]

In *Futura*, the court found that the focus of the test was on the "degree to which the plaintiff is dependent upon the expertise and efforts of others."[62] In addition, the court identified several more factors that, in addition to the factors identified in *McClure*, are important to consider, including: (1) the size of the offering;[63] (2) the purpose of both parties in entering into the transaction; (3) the economic inducements held out to the purchaser; (4) the degree to which the profit on the note is in the hands of the maker rather than the payee; and (5) whether the note was serving as a cash substitute for the purchase price and thus was commercial.[64]

This unrestricted use of relevant factors "gave the test both elasticity in addressing the novel types of financing arrangements and a certain degree of analytical imprecision."[65] Although the courts did not clarify how the various factors should best be ordered or weighted, commentators suggest that they showed "considerable facility" in ultimately distinguishing commercial notes from investment notes.[66] With its emphasis on

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[60] *See Futura*, 761 F.2d at 41 (explaining that other considerations may also be relevant in a particular case).

[61] 497 F.2d at 493-494.

[62] *Futura*, 761 F.2d at 40. The court explained that the purpose of the securities laws was to restore investor confidence in financial markets and to enhance the free flow of capital. In adopting the commercial/investment test, the court stated: "[w]e believe that the investment/commercial test can best effectuate these purposes because it directly focuses on the investor's dependency on the efforts of others and the investor's dependency upon financial disclosures provided by the other party." *Id.* at 40-41.

[63] This factor focused on whether the note was offered in a one-on-one transaction in a "tailor made" sales agreement or a transaction of notes offered in bulk to a mass of offerees. *Id.* at 41.

[64] *Id.*

[65] Loss & Seligman, *supra* n. 52, at 936.

[66] *Id.* at 936-937. One of the most important factors was the nature of the assets acquired in exchange for the notes. *Id.* at 937. Where the asset acquired by exchange of the note was investment, such as investment property or revival of a business, the note was a security. *SEC v. Diversified Indus., Inc.*, 465 F. Supp. 104, 109 (D.D.C. 1979); *SEC v. Contl. Commodities Corp.*, 497 F.2d 516, 526-527 (5th Cir. 1974). But bank loans to help fund ongoing business operations, loans made to help purchase a business when the lender was not an investor in the enterprise, and real estate loans made with conventional collateral were commercial, rather than investment, and thus, were not securities. *Bellah v. First Natl. Bank of Hereford, Tex.*, 495 F.2d 1109, 1113 (5th Cir. 1974); *C.N.S. Enters., Inc. v. G. & G. Enters., Inc.*, 508 F.2d 1354, 1362-1363 (7th Cir. 1975); *Bank of Am. Natl. Trust & Sav. Assn. v. Hotel Rittenhouse Assocs.*, 595 F. Supp. 800, 805 (E.D. Pa. 1985); Loss & Seligman, *supra* n. 52, at 937-938.

distinguishing commercial notes from investment notes, the test upholds the Supreme Court's rulings that the underlying economic realities of the transaction, rather than the form or title of the transaction, should determine whether an instrument is an investment and thus, a security.

2. Risk Capital Test[67]

The basic inquiry in the risk capital test is "whether risk capital has been contributed subject to the entrepreneurial or managerial efforts of another."[68] In *Great Western Bank & Trust v. Kotz*,[69] the court developed a six-factor test to help courts distinguish between a note that is a security and a note that is merely a risky loan.[70] The factors included: (1) the note's duration, (2) the existence and extent of collateralization, (3) the form of the obligation, (4) the circumstances of issuance, (5) the relationship between the amount borrowed and the size of the borrower's business, and (6) the contemplated use of the proceeds.[71]

Commentators have supported this test as a method to identify a note that is a security because risk is an important factor that distinguishes securities from commercial transactions.[72] However, the test has been criticized for at least two reasons: first, risk depends on the obligor's financial standing rather than the characteristics of the transaction;[73] second, the test presumes an instrument is not covered by the Securities Acts, thus placing the burden of proof on the party asserting coverage under the Securities Acts to show that the note was issued as an investment rather than as part of a commercial loan.[74] Thus, this test presumes that a note is not a security in contravention of the Supreme Court's interpretation of the Securities Acts that a note is presumed to be a security unless otherwise shown.[75]

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[67] The Ninth and Sixth Circuits applied this test. *See Great W. Bank & Trust v. Kotz*, 532 F.2d 1252, 1257 (9th Cir. 1976); *Union Planters Natl. Bank v. Com. Credit Bus. Loans, Inc.*, 651 F.2d 1174, 1182 (6th Cir. 1981).

[68] Scott D. Museles, *To Be or Note to Be a Security: Reves v. Ernst & Young*, 40 Cath. U. L. Rev. 711, 730 (1991).

[69] 532 F.2d at 1257-1258.

[70] Loss & Seligman, *supra* n. 52, at 940.

[71] *Union Planters*, 651 F.2d at 1182.

[72] Museles, *supra* n. 68, at 731.

[73] *Id.* at 731-732.

[74] *Id.*

[75] *Reves*, 494 U.S. at 65.

3. *Howey* Test[76]

The *Howey* test was the first test to require elements, rather than factors, to determine whether a note is a security.[77] Originally developed to determine whether a transaction was an investment contract and thus, regulated by the securities laws,[78] some courts expanded the application of the test to notes.[79] Under this test, a note is a security if it evidences: (1) an investment; (2) in a common enterprise; (3) with a reasonable expectation of profit; (4) to be derived from the entrepreneurial or managerial efforts of others.[80] Because all of the elements must be met before a court applying this test will label the note as a security, the test initially presumes that a note is not a security, but the presumption can be rebutted by proving all four elements.[81]

4. Second Circuit Family Resemblance Test[82]

Fearing that the balancing of factors approach required by the risk capital and commercial/investment tests might lead to inconsistent results, the Second Circuit, in *Exchange National Bank v. Touche Ross & Co.*,[83] sought to expound a more certain test that would be easier for courts to apply and would closely match the definition of "security" in the Securities Acts.[84] Because the plain terms of the Securities Acts list "notes" in the definition of "security," the presumption is that a note is a security, and the party asserting that a note is not within the scope of the Securities Acts has the burden of showing that the note is not an investment.[85] However, because some types of notes are clearly commercial, rather than investment, the court provided a shortcut by enumerating a list of notes that are not

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[76] The Eighth and District of Columbia Circuits applied the *Howey* test. *See Arthur Young & Co. v. Reves*, 856 F.2d 52, 54 (8th Cir. 1988) (stating that for the demand notes at issue to be securities, they must first satisfy the elements of the *Howey* test); *Baurer v. Planning Group, Inc.*, 669 F.2d 770, 778 (D.C. Cir. 1981) (finding that the *Howey* test embodies the essential attributes of a security).

[77] *Howey*, 328 U.S. at 298-299. *Howey* formulated a test for determining if a transaction was an investment contract, but some courts also applied the *Howey* test to determine if a note was a security. *See supra* n. 76.

[78] *Howey*, 328 U.S. at 293.

[79] *Id.*

[80] *Id.* at 298-299.

[81] *Id.*

[82] *Exch. Natl. Bank of Chi.*, 544 F.2d at 1138.

[83] *Id.*

[84] *Id.* at 1138.

[85] *Id.* at 1137-1138.

covered by the Securities Acts because they are always issued in the commercial context.[86] Although the court did not explain what features made these notes commercial rather than investment instruments, the court included the following notes in its enumerated list:

> [T]he 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.[87]

Realizing that it would be virtually impossible to predict and identify every type of note that was clearly not an investment, the court clarified that the list was "not graven in stone," and courts could add additional categories of non-security type notes.[88]

The Second Circuit defended its approach by stating that the family resemblance test "adhere[s] more closely to the language of the statutes and it may be somewhat easier to apply than the weighing and balancing of recent decisions of sister circuits."[89] One critic suggests that the court failed, however, to articulate any principles by which it "created, expanded, or decided the limits of its 'family.'"[90] Rather, the court merely provided a list without explaining or justifying its choice of items on the list.

5. Supreme Court's Adoption and Modification of the Family Resemblance Test

The Supreme Court resolved the circuit court split as to the appropriate test to use when determining whether a note is a security by adopting the family resemblance test. When faced with the issue of whether a demand note issued by a Co-Op was a security within the meaning of the 1934 Securities Act, the Supreme Court had to decide which of the tests

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[86] Notes issued in the commercial context are not securities, and thus, are not regulated by the Securities Acts. The enumerated list which includes commercial-type notes provides an efficient means by which issuers of notes can know that the contemplated issuance of a particular note is not a security subject to the reporting requirements of the Securities Acts.

[87] *Exch. Natl. Bank*, 544 F.2d at 1138. In a subsequent case, the court added to the list "notes evidencing loans by commercial banks for current operations . . . ." *Chem. Bank v. Arthur Anderson & Co.*, 726 F.2d 930, 939 (2d Cir. 1984).

[88] *Chem. Bank*, 726 F.2d at 939.

[89] *Exch. Natl. Bank*, 544 F.2d at 1138.

[90] McGinty, *supra* n. 9, at 1072.

employed by the circuit courts it would use to determine whether the note was a security.[91] After reviewing the purpose of the Securities Acts, the Court acknowledged that not all notes are securities.[92] Congress intended for the Securities Acts to protect investors only from the risk of notes that are investments.[93] Because Congress intended the Securities Acts to regulate investment notes, and not all notes, the Supreme Court emphasized that the SEC and the federal courts have a duty to determine whether coverage of the Acts should apply to a particular note.[94] If a note is issued in a commercial context, rather than in an investment context, Congress did not intend to regulate such a note, and the Securities Acts do not apply. But if the note is clearly issued for investment purposes, Congress intended that the provisions of the Securities Acts, which are designed to protect investors, should apply.[95]

The *Reves* Court first rejected the approaches of the courts that had applied the *Howey* test to notes. Justice Marshall viewed the *Howey* test as a mechanism for determining whether an instrument is an investment contract.[96] He stated that to apply the *Howey* test both to determine (1) if a note is a security, and (2) if a transaction is an investment contract, "would make the Acts' enumeration of many types of instruments superfluous . . . ."[97] The Court acknowledged that the family resemblance test and the commercial/investment test were two ways of formulating the same general approach, but because the Court believed that the family resemblance test provided "a more promising framework," it adopted a modified version of the Second Circuit's family resemblance test.[98]

The Court accepted the presumption that a note is a security, as well as

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[91] *Reves*, 494 U.S. at 60.

[92] *Id.* at 63. The purpose of the Securities Acts is to regulate investments – not commercial transactions. Sen. Rpt. 73-47 at § 4 ("Notes, drafts, bills of exchange, and bankers' acceptances which are commercial paper and arise out of current commercial, agricultural, or industrial transactions," are exempted from coverage under the Securities Acts).

[93] Sen. Rpt. 73-47 at § 1.

[94] *Reves*, 494 U.S. at 61, 65. In order for the federal securities laws to apply to a particular note, the transaction must utilize the means and instrumentalities of interstate commerce. 15 U.S.C. § 77e.

[95] *Reves*, 494 U.S. at 61.

[96] *Id.* at 64.

[97] *Id.*

[98] *Id.* at 65. Although the Supreme Court did not explain why the framework of the family resemblance test seemed so promising, one writer has inferred that the test was promising because it begins with a presumption of coverage for notes, and it lists specific non-security categories of notes. Lynn T. Burleson, *When Is a Note a Security? A Historical Perspective on the Supreme Court's Adoption of the Family Resemblance Test: Reves v. Ernst & Young*, 24 Creighton L. Rev. 371, 391 (1990). By adopting the family resemblance test, the Supreme Court resolved the circuit split as to the appropriate test to apply. Thus, the current state of this area of securities law requires that all courts apply this test in determining whether a note is a security.

the Second Circuit's enumerated list of notes that are non-securities.[99] The Court was unsatisfied, however, with merely enunciating a list of notes that are non-securities. It recognized that it would be difficult to determine whether there was a family resemblance with the notes on the list without understanding what it was about the notes on the list that made them non-securities.[100] To determine the common characteristics that the notes on the enumerated list exhibited that made them non-securities, the Court identified four factors that it inferred the Second Circuit had applied, but neglected to identify, in creating the list. The factors are:

(1) Examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it.[101]

(2) Examine the plan of distribution to determine if it is an instrument in which there is "common trading for speculation or investment."[102]

(3) Examine the reasonable expectations of the investing public.[103]

(4) Examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.[104]

The Court did not describe how to apply this four-factor test. Thus, it was unclear (1) whether all the factors should be satisfied, (2) whether the factors should merely weigh in favor of the note being a security, and (3) how to assess a factor that had contradictory aspects.[105]

The Court summarized its version of the family resemblance test:

> A note is presumed to be a "security," and that presumption may be rebutted only by a showing that the note bears a strong resemblance

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[99] *Reves*, 494 U.S. at 65-66. *See* McGinty, *supra* n. 9, at 1075 (criticizing the Court's decision to fabricate a pedigree because even the Second Circuit itself never justified its "family" of excluded notes).

[100] *Reves*, 494 U.S. at 65-66.

[101] "If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a 'security.'" *Id.* at 66. On the other hand, "[i]f the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, . . . the note is less sensibly described as a 'security.'" *Id.*

[102] *Id.*

[103] "The Court will consider instruments to be 'securities' on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not 'securities' as used in that transaction." *Id.*

[104] *Id.* at 67.

[105] For example, if a seller had commercial purposes in issuing a note, but the buyer had investment purposes in accepting the note, these aspects of the first factor contradict each other, and it is unclear whether the factor in this case favors a security or a non-security.

> (*in terms of the four factors we have identified*) to one of the enumerated categories of instrument. If an instrument is not sufficiently similar to an item on the list, the decision whether another category should be added is to be made by examining *the same [four] factors.*[106]

Thus, the Court gave an issuer-defendant two opportunities to apply the four-factor test: first, to determine whether a particular note bears a strong family resemblance to a note on the enumerated list; second, to determine whether a note that does not bear a strong family resemblance to a note on the list under the first application of the four factors should be added to the list as a new category of non-security-type note.[107]

After articulating a concise description of the test, the Court applied the test to the facts in *Reves*. Unfortunately for subsequent parties, courts, and counselors, the defendants in *Reves* conceded that the demand notes at issue did not bear a strong family resemblance to any category of note on the list.[108] Because it was unnecessary for the court to determine if the demand notes bore a strong family resemblance to the notes on the list, it did not show future courts by way of example how to apply the first application of the four factors to find a family resemblance with notes on the list. Instead, the Court only applied the four-factor test once to determine if the demand notes at issue ought to be added to the list as an additional category of non-security notes.[109]

In its analysis, the Court found that all four factors favored a security classification and did not add the note as a new category of non-security note.[110] This was also unfortunate because due to the fact that all four factors favored a security, the Court was not required to demonstrate how to weigh or apply the factors in a case where all the factors do not clearly favor finding a security. Thus, the Court failed to demonstrate how to apply two aspects of the family resemblance test: (1) how to apply the same four factors in two different steps of the test; and (2) how to assess the four factors.

C. *Post-*Reves *Reactions to the Family Resemblance Test*

Although the Supreme Court's intentions were good in seeking to

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[106] *Reves*, 494 U.S. at 67 (emphasis added).

[107] *Id.*

[108] *Id.*

[109] *Id.* at 67-70.

[110] *Id.* at 70.

articulate a uniform test having a "promising" framework to aid future courts in determining whether a note is a security, legal scholars' responses to the family resemblance test indicated that the Supreme Court was a minority in its confidence in the test. Commentators predicted the questions raised by the Court's articulation of the test. They predicted that these questions would inevitably lead to inconsistent applications of the test in the years following the decision.[111] Some rejected the Court's modification of the Second Circuit's test, stating that the Second Circuit's list of highly specific exclusions was predictable and by adding four factors the Court destroyed the family resemblance test's predictability.[112] Because *Reves* left each court to decide for itself what meaning or relative weight to give to the factors, a court will, in essence, "know it when it sees it."[113] This indefinite standard will "expand securities law coverage of notes."[114] While the Supreme Court's intent was clear in allowing plaintiffs a rebuttable presumption that the note in question is a security, the "'family resemblance' test to be employed in effecting this intent is muddy."[115] In a word, the family resemblance test is "dysfunctional."[116] Some legal writers even predicted that *Reves* was only a transitional case and that "[a]s anomalies mount up throughout the federal judiciary, the Supreme Court may well have to impose a clearer test to correct *Reves*."[117] In hindsight, commentators were wrong that the Supreme Court might impose a clearer test, but were correct that the Supreme Court's articulation of the test would lead to muddied applications of the test by the courts.

III. ANALYSIS

Contrary to analyses and predictions after *Reves*, over twelve years have passed since the Supreme Court's adoption of the family resemblance test, and the Supreme Court has neither clarified nor changed the test. As predicted, however, courts are still struggling to interpret the test. In

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[111] *See* Janet Kerr & Karen M. Eisenhauer, *Reves Revisited*, 19 Pepp. L. Rev. 1123, 1162 (1992) (arguing that the test provides little guidance or comfort due to its inherent ambiguities as evidenced by a study of case law in the two years following *Reves*); Cody, *supra* n. 21, at 800.

[112] *See e.g.*, McGinty, *supra* n. 9, at 1080 (arguing that the *Reves* test transformed the Second Circuit's predictable test into a manipulable test lacking a definite standard, which will "spawn[ ] defective lawmaking").

[113] *Id.* at 1077.

[114] Mark I. Steinberg, *Notes as Securities: Reves and Its Implications*, 51 Ohio St. L.J. 675, 679 (1990).

[115] Cody, *supra* n. 21, at 826.

[116] *Id.*

[117] McGinty, *supra* n. 9, at 1080.

examining how past courts have applied the test, much of the usefulness that the Supreme Court perceived in its formulation of the family resemblance test has gone ignored and unapplied. The Court could have formulated a more effective test by melding together the positive characteristics of existing tests with which courts were familiar and knew how to apply. This Comment will describe the specific points of confusion that federal courts have experienced in applying the family resemblance test over the past twelve years, explain the consequences of inconsistent applications and results of the test, and will propose a test that is both consistent with the purpose of the Securities Acts and provides courts with freedom to evaluate a note with confidence that it has not overstepped the boundaries of an unclear, yet restrictive test.

A. *Applying the Four Factors Twice Results in a Duplicative Analysis: How Does the Second Application of the Four Factors Result in a Different Conclusion Than the First Application of the Same Four Factors?*

1. An Examination of Recent Courts' Treatments of the Duplicity of Two Applications of the Four Factors

The family resemblance test requires that courts apply the four-factor test twice: first, to determine if the note in question bears a strong family resemblance to the notes on the enumerated list, and second, to determine if the note should be added as a new category to the list if the court does not find a family resemblance after the first application of the four factors.[118] An examination of court decisions applying the family resemblance test shows that many courts skip the first application of the four factors, and instead, apply the four factors only once to determine if a note does or does not have security characteristics.

These courts, rather than finding a family resemblance in terms of the four factors as the Court instructed, determine the existence of a family resemblance merely by comparing the note in question to the commercial characteristics of the individual types of notes enumerated on the list. For example, a court examines a note in question, and if it has the commercial features of a mortgage note (or some other note on the enumerated list), the court concludes that it, too, is a non-security-type note. However, if the court preliminarily determines that a note does not resemble the commercial features of any type of note on the list, it then applies the family resemblance test's four factors for the first and only time to determine if the

[118] *Reves*, 494 U.S. at 67.

note in question has the non-security characteristics encompassed by the four factors and should be added as a new category to the list of non-security notes.

Thus, the first breakdown in the test arises in the required first application of the four factors – when courts attempt to find a strong family resemblance with notes already on the list. In the two cases that follow, the courts, in the first step of their analyses, compared the notes in question to the notes on the enumerated list in terms of the notes' commercial features, and only applied the family resemblance test's four factors in the second step of their analyses to determine if a new category of note should be added to the enumerated list.

In *Holloway v. Peat, Marwick, Mitchell & Co.*,[119] the court determined that under the first step of the family resemblance test, the instruments at issue did not resemble any category on the enumerated list of non-securities.[120] However, this conclusion did not follow any analysis in terms of the four factors as the *Reves* Court instructed. The court did not apply the four factors until step two of the family resemblance test when, for the first time, it "examine[d] the instruments in light of the four guideline factors to decide whether these instruments should be added to the judicial list of non-securities."[121] Thus, the court did not apply the four factors to find a family resemblance with the notes on the list as required in the *Reves* Court's articulation of the family resemblance test, but merely to determine if a new category of note should be added to the list.

Similarly, in the recent Ninth Circuit decision in *McNabb v. Securities and Exchange Commission*,[122] the defendant argued that the promissory notes in question bore a family resemblance to either a bank character loan or a commercial loan to maintain business operations.[123] The court, like *Holloway*, concluded "[a]fter a thorough review," that the promissory notes in question did not strongly resemble either of the types of notes on the enumerated list.[124] Like *Holloway*, this conclusion lacked any supporting analysis in terms of the four factors. In fact, the court never indicated what

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[119] 900 F.2d 1485 (10th Cir. 1990).

[120] *Id.* at 1487. The first step of the family resemblance test involves application of the four factors to determine if the note in issue bears a strong family resemblance to the notes already on the enumerated list. *Reves*, 494 U.S. at 67.

[121] *Holloway*, 900 F.2d at 1487. Step two of the family resemblance test involves an application of the four factors to determine if a note not bearing a strong family resemblance to the notes on the enumerated list should be added as a new category of note to the list. *Reves*, 494 U.S. at 67.

[122] 298 F.3d 1126 (9th Cir. 2002).

[123] *Id.* at 1131. Both of these types of notes are on the enumerated list.

[124] *Id.*

it considered in its "thorough review."[125] Instead, the court did not apply the family resemblance test's four factors until *after* it concluded there was no family resemblance with the notes on the enumerated list and applied the four factors only to determine whether an additional category of note should be added to the list of non-securities.[126] Thus, like *Holloway*, in the first step of its analysis, the court looked for a family resemblance with the notes on the list in terms of commercial features, rather than in terms of the family resemblance test's four factors.

These courts did not acknowledge that they were only applying the four factors once instead of twice as the *Reves* Court instructed. But at least one court has acknowledged the redundancy in applying the same four factors in both steps of the analysis. In the recent decision of *Securities and Exchange Commission v. Wallenbrock*,[127] after describing the family resemblance test in the terms used by the Supreme Court, the court interpreted the test as follows:

> Although courts have treated this analysis as two separate steps, both inquiries involve the application of the same four-factor test, and so the two essentially collapse into a single inquiry. Although the multi-factor test was originally conceived as a method of ascertaining whether an instrument resembles a non-security, the Supreme Court has since framed it as an analysis of "whether an instrument denominated a 'note' is a 'security.'"[128]

Thus, the *Wallenbrock* court recognized that courts should only apply the family resemblance test's four factors once because any further applications of the four factors will result in the same inquiries and conclusions.

2. The First Application of the Four Factors

The Supreme Court intended that the first application of the four factors would assist courts in determining whether a note bears a strong family resemblance to the notes on the enumerated list.[129] The question arises whether the resemblance should be found in terms of commercial features or non-security-type features. As shown above, some courts determine a

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[125] *Id.* Although the court did not disclose what it considered in its review under the first step of the family resemblance test, the court likely compared the note to the notes on the enumerated list in terms of commercial features and failed to find a resemblance.

[126] *Id.*

[127] 313 F.3d 532 (9th Cir. 2002).

[128] *Id.* at 537.

[129] *Reves*, 494 U.S. at 67.

family resemblance in terms of the commercial features of the notes. This may be because nothing about the four factors helps to determine if a note bears a family resemblance to the specific commercial features of the notes on the list. For example, applying the four factors will not help a court determine if a note is similar to the commercial features of a note delivered in consumer financing, a short-term note secured by a lien on a small business, or a short-term note secured by an assignment of accounts receivable.[130] Because courts are supposed to use the same four factors to determine a family resemblance in an analysis of all types of notes, the Supreme Court could not have intended that courts determine a family resemblance by examining the commercial features of notes. There is no room within the four factors for an independent analysis of each category of note in terms of its unique commercial features.

In contrast, the four factors do help to determine if a note is a security.[131] In adopting the Second Circuit's enumerated list of non-security notes, the Supreme Court inferred that the Second Circuit court included categories of notes on the enumerated list that have the non-security characteristics encompassed by the four factors (an application of the factors cuts in favor of a non-security).[132] This leads to the conclusion that any note having the *non-security* characteristics encompassed by the family resemblance test's four factors should be included in the "family" of notes sharing these characteristics. Likewise, if an application of the family resemblance test's four factors leads to the conclusion that the note in question has the *security* characteristics of the four factors, the note does not belong in the "family" of notes that have *non-security* characteristics. Under this analysis, after the first application of the four-factor test, it would be evident to a court whether the note has the characteristics of a non-security, and thus, does not fall within the ambit of federal securities regulation. Likewise, it would be clear after the first application of the four factors if the note is a security and thus, covered by the securities laws.

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[130] *Id.* at 65.

[131] *Id.* at 66. Specifically, if an application of the four factors cuts in favor of a *security*, i.e.: (1) if the seller's purpose is to finance substantial investments, and the buyer is interested in making a profit; (2) the instrument involves common trading for speculation or investment; (3) the investing public reasonably expects that the note is a security; and (4) there is no other factor that significantly reduces the risk of the instrument, the instrument has the characteristics of a security that Congress intended to regulate. On the other hand, if an application of the four factors cuts in favor of a *non-security*, i.e.: (1) the seller's and buyer's purposes are wholly commercial; (2) the transaction is tailor-made; (3) the investing public expects that the instrument is not an investment; and (4) there exists a risk-reducing factor, the instrument has the characteristics of a non-security that Congress did not intend to regulate under the securities laws. *See Id.* at 66-67.

[132] *Id.* at 66.

3. The Second Application of the Four Factors

Although a court applying the four factors in the first step would know whether a note is a security and consequently covered by the securities laws, the family resemblance test requires that courts take a further step and apply the same four factors again to see if a note *not* having the characteristics of a non-security, like the notes on the list, should be added as a new category of non-security-type note to that list.[133] This second step is where much of the courts' confusion lies. If a court decides, after applying the four factors for the first time, that the note does not bear a strong family resemblance to the family of non-security notes because the note in question is a security, applying the same four factors a second time will not transform a note that is a security into a note that is a non-security that should be added to the list.

Courts have intuitively discerned this redundancy in applying the family resemblance test's four factors twice when both applications should result in the same conclusion that the note does or does not share the non-security features of the notes on the list. Indeed, a note can only be one of two things: a security or a non-security. The conclusion will be the same regardless of the number of times a court applies the four factors.

As shown, to avoid this redundancy, many courts test for a family resemblance by comparing a note in question to the notes on the list, not in terms of the four factors, but in terms of the commercial features of the note. If the courts do not find a family resemblance in terms of commercial features, they are comfortable applying the four factors once to determine if the note should be added to the list as a new category of notes. This type of application makes sense. After all, the benefit of the enumerated list shortcut is that an issuer of a note can know right away that it is issuing a non-security if the note falls into one of the commercial categories in the list. If the issuer is not issuing a type of note that falls into one of the commercial categories in the list, then applying the four factors will aid the issuer in determining if it is issuing a security or a non-security. Although looking for a family resemblance in terms of the commercial features of a note in the first step of the test, rather than in terms of the four factors unique to the family resemblance test makes sense, however, this application results in one breakdown of the test as articulated by the Court.

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[133] *Id.* at 67.

4. Many Courts Use the Four Factors to Test For a Security, Rather than Testing For a Family Resemblance

Another breakdown occurs when courts use the family resemblance test's four factors to determine whether a note is a security, rather than to determine if the note bears a strong family resemblance to the notes on the list.[134] Although the result is the same if a court applies the four factors to determine a *family resemblance* to non-security-type notes or to determine whether the note is a *security*, courts appear to intuitively apply the four-factor test to determine the ultimate inquiry of whether the note in question is a *security*, rather than whether the note meets the middle step of bearing a *family resemblance* to notes on a list, which necessarily means that the note is a non-security. An examination of several court decisions will highlight this distinction that represents yet another breakdown of the family resemblance test.[135]

In *Trust Company of Louisiana v. N.N.P., Inc.*,[136] after setting forth the family resemblance test, the court began:

> Applying the family resemblance approach to this case, we have little difficulty in concluding that the TCL notes at issue are "securities." The notes do not closely resemble any of the family resemblance examples. Nor does an examination of the four factors suggest that the notes are not *securities*.[137]

Two points are worth noting: First, like the decisions in *Holloway* and *McNabb*, the court in *Trust Co. of Louisiana*, rather than applying the four factors to find a family resemblance with the notes on the enumerated list, merely concluded that the notes did not resemble any notes on the list. Although the court did not describe its analysis in this step, it likely involved an examination of the note in terms of the commercial features of the notes on the list. Second, the court only later applied the four factors for the first time to determine if the note was a *security*, rather than if the note

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[134] *Infra* nn. 138-144 and accompanying text. Whether or not the instrument is a security is really the ultimate question because the Securities Acts only regulate securities. Thus, although the pertinent test for notes is currently the family resemblance test, this test is only a means by which courts answer the ultimate inquiry. By not using the four factors to determine a *family resemblance*, and instead using them to determine whether the note is a *security*, courts are bypassing the intended usefulness of the family resemblance test and merely applying a version of the previously applied factor tests (i.e, the risk capital test and the commercial/investment test). *See* II(B)(2); II(B)(1) (discussing the risk capital test and the commercial/investment test).

[135] In the examination of cases that follow, the author will use emphases to denote when a court is determining if the note bears a family resemblance to the notes on the enumerated list, and when a court is determining if the note is a security.

[136] 104 F.3d 1478 (5th Cir. 1997).

[137] *Id.* at 1489 (emphasis added).

bore a family resemblance to the notes on the list.

Likewise, in *Securities and Exchange Commission v. Tyler*,[138] the first step of the court's analysis was a conclusion that the notes did not fall into any of the excluded categories – a conclusion reached without applying the family resemblance test's four factors.[139] Because the note did not fall into any of the categories on the enumerated list, the court proceeded with its interpretation of the family resemblance test and framed the second step of its analysis as follows:

> Once the court determines that a note is not one specifically excluded, the Second Circuit provided guidance for what sorts of notes would be included in the definition of "security." The Supreme Court, adopting the Second Circuit's reasoning, set out four factors to examine when determining if a specific note is a *security*.[140]

After the court's initial conclusion that the note did not fall into one of the excluded categories, it did not discuss the issue of family resemblance any further.[141] Although the *Reves* Court intended courts to use the four factors to find a family resemblance, the *Tyler* court, like the *Trust Co. of Louisiana* court, applied the family resemblance test's four factors as yet another multi-factor test to determine if the note was a *security*, rather than to find a *family resemblance*. Other than the benefit of the enumerated list of notes that are per se non-securities that the court could use to compare the note in question, the court did not utilize any other unique aspects of the family resemblance test.[142]

Because courts are not applying the family resemblance test's four factors to find a family resemblance with the notes on the list, and because when many courts do apply the four factors, they do so to determine if a note is a *security*, the family resemblance test is effective only to the extent that courts use the shortcut of the enumerated list – if a note falls squarely into one of the enumerated categories of notes, it is per se a non-security.[143] Beyond that, courts are merely applying the latest multi-factor test to determine if a note is a security.

In order to restore the family resemblance test, the Supreme Court could eliminate the duplicity of the second application of the four factors by (1) allowing courts to compare a particular note to the notes on the

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[138] 2002 U.S. Dist. LEXIS 2952 (N.D. Tex. Feb. 21, 2002).

[139] *Id.* at *11.

[140] *Id.* (emphasis added).

[141] *Id.*

[142] *Id.*

[143] *See e.g. id.* at *11.

enumerated list in terms of the commercial features, and (2) requiring only one application of the four factors to determine if a note shares the non-security features of the four factors with the notes on the numerated list. This approach would validate what many courts are already doing when they apply the family resemblance test.

B. The Questions Raised By the Court's Explanation of the Four Factors Are True of Any Multi-Factor Test, But This Does Not Justify Replacing the Multi-factor Test With an Elements Test

Even if the Supreme Court were to eliminate the duplicative steps in the family resemblance test, however, courts have expressed uncertainty about how to apply the four factors themselves.[144] Although the Supreme Court gave a brief description of each factor,[145] the Court failed to explain: (1) whether all four factors must be satisfied to rebut the presumption that a note is a security (in which case they are really elements), or whether courts should instead use a balancing test; (2) whether any factor is more important than another;[146] and (3) what to do in the case of a "washout."

Most courts have applied a balancing approach.[147] But within the balancing approach, some courts look to the *number* of factors that favor finding a non-security,[148] while other courts place more importance on particular factors. To illustrate the latter, the court in *LeBrun*[149] found that because the motivations of the buyer and seller in factor one and the expectations of the investing public in factor three are generally unclear and multiple, the family resemblance test will often turn on factor two – the

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[144] Perhaps the court in *LeBrun v. Kuswa*, best explained the ambiguities with respect to the application of the four factors:

> [I]n *Reves*, the Supreme Court failed to state the method for applying these factors. The language is ambiguous as to whether all four factors must be met, or whether a balancing approach should be utilized. While this Court concludes that a balancing approach is most suitable, the relative weight to be assigned to each factor remains unclear. This Court will employ the balancing test, keeping in mind that the economic realities must be considered.

24 F. Supp. 2d 641, 646 (E.D. La. 1998) (footnotes omitted).

[145] *Supra* nn. 101-104 and accompanying text (listing the four factors).

[146] *Reves*, 494 U.S. at 66-67.

[147] *See infra* n. 148.

[148] *See e.g. Stoiber v. SEC*, 161 F.3d 745, 752 (D.C. Cir. 1998) (finding that the promissory notes in question were non-securities where three of the factors cut in favor of a non-security, despite the fact that one of the factors cut in favor of a security); *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1280 (S.D. Ohio 1996) (finding that after balancing all of the *Reves* factors, the notes were not covered under the Securities Acts despite the fact that factor four cut in favor of a security); *Wallenbrock*, 313 F.3d at 537 (clarifying that "[f]ailure to satisfy one of the factors is not dispositive; they are considered as a whole").

[149] 24 F. Supp. 2d at 641.

plan of distribution.[150] Moreover, legal scholars have recognized that the fourth factor – the presence of a risk-reducing factor – can be dispositive of whether a note is a security.[151] Thus, even though applying a balancing approach, courts have regarded some factors as more important than others.

In addition to the *LeBrun* court, other courts have also noted the problem of "washout," where the application of one factor is indicative of both a security and a non-security.[152] For example, with respect to the motivations of the buyer and seller in factor one, if the buyer's motivation is to realize a profit (indicative of a security), but the seller's motivation is to correct for the seller's cash-flow difficulties (indicative of a non-security), the opposite motivations are a "washout," and it is difficult to weigh that particular factor in a balancing test. Additionally, the washout problem commonly arises when applying factor three – the reasonable expectations of the investing public – because what is a reasonable expectation to one segment of the investing public may not be a reasonable expectation to another segment based on objective evidence and because of the inherent difficulty in ascertaining the expectations of the investing public in general.[153] The effect of the "washout" problem is that the factor resulting in a "washout" has no effect on the overall analysis. That factor cannot favor either security or non-security because it favors both. Thus, if one factor results in "washout," the court is left with only three factors to balance. This reduction in factors further narrows the scope of the four-factor analysis.

However, these perceived weaknesses of the four factors are weaknesses of any multi-factor test. To some degree, every multi-factor test is unpredictable and may result in inconsistent results.[154] But the drawbacks of multi-factor tests do not justify replacing them with element tests that are more predictable.[155] In the area of securities law, multi-factor tests "provide courts with maximum flexibility to effectuate the objectives" of Congress in regulating only securities in whatever form they may be.[156] Multi-factor tests allow courts to take into account more relevant considerations than

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[150] *Id.* at 646.

[151] Museles, *supra* n. 68, at 746-748.

[152] *See e.g. Bass v. Janney Montgomery Scott, Inc.*, 210 F.3d 577, 585 (6th Cir. 2000) (finding that factors one and three were washouts).

[153] *Id.*

[154] Christopher J. Plaisted, *Too Much of a Good Thing: When Government Involvement in Waste Disposal Crosses the Line Between Regulating and "Operating" Under CERCLA*, 22 W. New. Eng. L. Rev. 221, 264 (2000) (noting that multi-factor tests result in an "adhoc factual analysis" that make the traditional multi-factor tests completely unpredictable).

[155] Eli J. Richardson, *Taking Issue With Issue Preclusion: Reinventing Collateral Estoppel*, 65 Miss. L.J. 41, 73 (1995) (explaining that element tests "are intended to promote clarity and certainty").

[156] Richardson, *supra* n. 155, at 84; *Reves*, 494 U.S. at 61.

element tests. In the area of securities law, courts have recognized that there is a "virtually limitless scope of human ingenuity, especially in the creation of 'countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.'"[157] This type of ingenuity requires a flexible test that can adapt to meet each new investment scheme. Whereas in element tests, the absence of a single element can preclude a particular result, in factor tests, each factor militates against or in favor of a security, with no single factor being dispositive.[158] For these reasons, due to the highly factual inquiries inherent in this area of securities law, multi-factor tests are more effective than element tests.

Despite the fact that confusion with a multi-factor test is to be expected, the four factors of the family resemblance test are too narrow to allow courts a global inquiry of the circumstances surrounding the transaction while at the same time effectuating Congress's intention to differentiate between commercial and investment notes.[159] With only four factors, the possibility exists that courts will exclude relevant evidence as to the status of a note if the evidence does not fall under the purview of one of the four factors. The four factors straitjacket courts into restrictive evaluations. In addition, if an application of one of the factors results in a wash, that factor does nothing to further a court's analysis. Thus, the court is left with only three factors to weigh. Moreover, a court may deem certain information significant to its decision, but will have a difficult time integrating the evidence into its analysis if the evidence cannot be categorized under one of the four factors (or fewer factors in the case of a washout).

C. *Effects of Misunderstanding and Misapplying the Family Resemblance Test*

The main effects of misapplying the family resemblance test are twofold. The first is uncertainty for the corporate planner, the issuer of notes, counsel for the issuer of notes, state securities regulators, and courts. One writer has identified when the issue of notes as securities can arise:

> Counsel for the issuer of a note may be called upon to opine whether the note is a "security," and if so, whether it needs to be registered or is exempt from registration. Additionally, state securities regulators encounter all types of investment products, legitimate and otherwise; such regulators must be able to determine

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[157] *Reves*, 494 U.S. at 60-61 (quoting *W.J. Howey Co.*, 328 U.S. at 299).

[158] Richardson, *supra* n. 155, at 84.

[159] Sen. Rpt. 73-47 at 3.

> which notes are "securities" and which are not, and if deemed a security, whether they must be registered. Finally, litigators need guidance in arguing this issue in civil, criminal, and administrative proceedings.[160]

The *Reves* Court recognized, as it had in earlier cases involving investment contracts, that the economic realities of the transaction are the pertinent indicia of whether the note is a security.[161] Thus, the Court intended that courts applying the family resemblance test look to the underlying economic realities of the transaction rather than the name.[162] The well-known securities scholar and professor, Marc Steinberg, commented that the economic reality determined by the four factors "offers little solace to the corporate planner," because unless a note falls squarely into one of the excluded categories of notes on the enumerated list, the four factors leave corporate lawyers and their clients with little definite guidance.[163] "Until sufficient precedent is developed, . . . unless an instrument comes within an excluded category or is nearly identical to such an instrument in all material respects, counsel planning a transaction would be prudent to assume that the federal securities laws apply."[164]

This is an unfortunate, although realistic, conclusion. Due to the time, expense, and effort involved in registering securities, it is worthwhile to have a clear test that will result in consistent applications, rather than registering "just in case" securities laws apply.[165] On the other hand, no issuer would want to be caught issuing securities without having first registered them. Therefore, as Professor Steinberg proposes, if notes do not clearly fall into one of the excluded categories, the safest course of action is to incur the time and expense of registering the securities.

The second effect follows from the first effect. If the uncertainty of the corporate planner or the issuer of the notes eventually culminates in a decision that the notes in question are not securities and the notes are subsequently issued without complying with the registration requirements

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[160] Kenneth L. MacRitchie, *Is a Note a "Security"? Current Tests Under State Law*, 46 S.D. L. Rev. 369, 370 (2000/2001).

[161] An economic-realities test is "[a] method by which a court determines the true nature of a business transaction or situation by examining the totality of the commercial circumstances." *Black's Law Dictionary* at 531.

[162] *Reves*, 494 U.S. at 61.

[163] Steinberg, *supra* n. 114, at 684.

[164] *Id.* (footnote omitted).

[165] Courts have recognized this outcome resulting from the uncertainty surrounding notes as securities. "[T]he securities laws involve elaborate registration and financial reporting requirements. . . . [S]ubjecting the maker of every note to the reporting requirements of the 1933 Securities Act would paralyze the business community rather than assist in the free flow of capital as Congress intended." *Futura*, 761 F.2d at 39 (citations omitted).

of the securities laws, the *consequence* of misunderstanding and misapplying the family resemblance test can give rise to administrative, civil, and criminal liability.[166] The serious consequences of misclassifying a note as a non-security indicate that courts, issuers, and corporate counsel must have a more definite, or at least a more familiar process by which to know whether the Securities Acts cover a particular note.[167]

D. *The Family Resemblance Test Is a Shorter Version of the Commercial/Investment Test, and a Reorganization of the* Howey *Test*

The family resemblance test is a by-product of both the commercial/investment test and the *Howey* test. While courts have had problems applying the family resemblance test, they have understood and successfully applied the latter two tests. Unlike the restrictive structure of the family resemblance test, the open-ended framework of the commercial/investment test allows courts to engage in a global inquiry based on all of the relevant evidence of a transaction to determine whether a note is issued in a commercial context or an investment context. The *Howey* test is inappropriate as a principal test for deciding whether a note is a security because it does not uphold the presumption that a note is a security unless otherwise shown.

1. Although the Structures of the Family Resemblance Test and the Commercial/Investment Test Are Different, the Four Factors of the Family Resemblance Test Resemble the Factors of the Commercial/Investment Test

The structure of the old commercial/investment test is broader than the structure of the family resemblance test. The focus of the commercial/investment test was on distinguishing notes that were investments from notes that were part of commercial transactions.[168] This

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[166] Hazen, *supra* n. 7, at 341.

[167] As described *supra*, the issue of whether a transaction is a security is highly factual, and a multi-factor test is better suited to encompass all of the relevant facts than is an element test, despite the fact that multi-factor tests are less certain than element tests. However, even within multi-factor tests themselves, some are more predictable than others. The commercial/investment test is more predictable than the family resemblance test because it provides a more familiar framework for courts than the uncertain and confusing four factor framework of the family resemblance test. Moreover, the framework of the commercial/investment test is more conducive to a global inquiry – considering all of the relevant evidence.

[168] Loss & Seligman, *supra* n. 52, at 936; *McClure*, 497 F.2d at 492 (explaining that "[a]lthough the Securities Exchange Act of 1934 provides that the term security means 'any' note, judicial decisions

test upheld Congress's purpose to regulate investments when it promulgated the Securities Acts.[169] Whether a note is commercial or investment in its purpose is not only the threshold inquiry for imposing coverage under the securities laws, it is the only inquiry. There is no middle analytical step as there is in the family resemblance test, wherein a determination of whether a note bears a family resemblance to the enumerated list must be made before the final step of concluding that it is or is not a security. In the commercial/investment test, if the note has the characteristics of an investment, it is a security. But if the note has the characteristics of an instrument used in a commercial transaction, and not as an investment, it is not a security.[170] Period.[171] Because there is only one inquiry, the test is not layered with subcategories of inquiries as is the family resemblance test.

Moreover, the commercial/investment test is essentially unrestricted. The facts of a particular transaction that indicate investments determine the status of the note as a security. Likewise, facts indicating a commercial transaction determine the status of the note as a non-security. Thus, courts employ a case-by-case approach that gives the test "elasticity in addressing novel types of financing arrangements . . . ."[172] Generally, such a flexible approach would inevitably lead to uncertainty and inconsistent results. However, commentators have noted that courts showed considerable facility evaluating the criteria to be considered in distinguishing commercial notes from investment notes.[173] Perhaps the courts' facility came about because the courts agreed that it was the economic reality of the transaction – whether a note was in actuality commercial or investment – that gave rise to coverage under the Securities Acts, rather than a superficial

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have restricted the application of the Act to those notes that are investment in nature and have excluded notes which are only reflective of individual commercial transactions").

[169] Sen. Rpt. 73-47 at 1. "The commercial/investment test is the one that is most in consonance with the legislative history of the Acts." Burleson, *supra* n. 98, at 391 (footnote omitted).

[170] Similar to the family resemblance test, courts applying the commercial/investment test recognized that "[m]any note transactions involve loan agreements, sales agreements, deeds of trust, mortgages, and personal security agreements" which are regulated by commercial law including the Truth in Lending Act, the Magnuson-Moss Warranty Act, antitrust laws, and the Uniform Commercial Code. *Futura*, 761 F.2d at 39 (citations omitted). "Regulation of some note transactions . . . should be left to the operation of these other laws." *Id.*

[171] *McClure*, 497 F.2d at 495 ("[T]he investment or commercial nature of a note entirely controls the applicability of the Act . . .").

[172] Loss & Seligman, *supra* n. 52, at 936. Because the characterization of a note as commercial or investment is made on a case-by-case basis, the factors that courts consider are merely "helpful" rather than binding. Simmons, *supra* n. 5, at 1129 (citing Loss & Seligman, *supra* n. 52, at 882).

[173] Loss & Seligman, *supra* n. 52, at 936-937. The commercial/investment test has been criticized due to the wide variation of factors among the courts, the lack of guidance as to the rank or relative weight of each factor, and the case-by-case analytical approach. Burleson, *supra* n. 98, at 390.

label and description of a note.[174] The flexibility of this test allowed courts to know an investment when they saw it, and under the undefined boundaries of the test, courts were free to take this approach.

Although this test was largely undefined, courts did consider a list of factors when reaching a decision on the status of a note.[175] This list of factors was not finite, and successive courts added to the factors based on the facts of the transaction before them.[176] These factors provided courts with direction, but with numerous factors, as well as the possibility of more, courts were not required to apply each and every factor. Thus, if a particular factor was ambiguous or unclear in application, courts had more than enough alternative factors on which to make their decisions.[177] In contrast, the family resemblance test's limited number of four factors restricts courts in their analyses for two reasons: first, there may be evidence that is

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[174] *Futura*, 761 F.2d at 39 ("[C]ourts must examine the substance or 'economic realities' of all alleged securities transactions and not rely on the form of the instrument to determine whether the transaction falls within the ambit of the federal securities laws.").

[175] In *McClure*, an early case applying the commercial/investment test, the court identified three factors that shed light on whether the promissory note was an investment: (1) whether the note was offered to some class of investors; (2) whether the note was acquired by the investor for speculation or investment; and (3) whether the note was offered in exchange for investment assets (i.e., long-term capital), rather than merely to pay off a business debt. 497 F.2d at 493-494.

In *Futura*, the court found that the focus of the test was on the "degree to which the plaintiff is dependent upon the expertise and efforts of others." 761 F.2d at 40 (citations omitted). The court explained that the purpose of securities laws was to restore investors' confidences in financial markets, and to enhance the free flow of capital. In adopting the commercial/investment test, the court stated that: "We believe that the investment/commercial test can best effectuate these purposes because it directly focuses on the investor's dependency on the efforts of others and the investor's dependency upon financial disclosures provided by the other party." *Id.* at 40-41.

The court identified several more factors in addition to those identified in *McClure* that are important to consider including: (1) the size of the offering; (2) the purpose of both parties in entering into the transaction; (3) the economic inducements held out to the purchaser; (4) the degree to which the profit on the note is in the hands of the maker rather than the payee; and (5) whether the note was serving as a cash substitute for the purchase price, and therefore, commercial. *Id.* at 41.

[176] *See* Simmons, *supra* n. 5, at 1140 (noting that the list of factors "can be supplemented with other factors deemed pertinent by a court . . .").

[177] Indeed, courts did not attempt to apply each and every factor to their decisions, but applied the ones most applicable to the transaction before them. *See Futura*, 761 F.2d at 41 (finding that the note was issued in a commercial transaction because: (1) the note was given as a result of one-on-one business negotiations; (2) the note served as a cash substitute for the sales price; and (3) the note's stated value was not dependent upon the entrepreneurial efforts of the issuer); *McClure*, 497 F.2d at 493-494 (finding that the promissory notes were not securities because: (1) the notes were not offered to some class of investors; (2) the notes were not acquired by the purchaser for speculation or investment; and (3) the issuer paid off a business debt in exchange for the notes and did not directly or indirectly obtain investment assets in exchange); *Hunssinger*, 745 F.2d at 492-493 (finding an absence of facts ordinarily associated with commercial loan transactions in that: (1) the issuer did not participate in a consumer purchase transaction; (2) none of the makers of the notes were in the trade or business of making consumer loans; and (3) none of the payees of the notes sold a business's assets or stock to the makers of the notes).

relevant but that does not fit under one of the four factors; and second, in the case of a washout of one or more factors, the even fewer remaining factors further restricts the courts.[178]

Despite these differences in the structures of the two tests, the four factors of the family resemblance test represent a selection of factors from the commercial/investment test. First, like the commercial/investment test, the family resemblance test looks to the motivations of the buyer and seller of the note – whether the buyer purchased and the seller sold for speculative or investment purposes.[179] Second, like the commercial/investment test's factor of whether the note was offered to some class of investors, the second factor of the family resemblance test examines the plan of distribution of the note and whether there is common trading.[180]

Third, the family resemblance test considers the reasonable expectations of the investing public.[181] If the investing public reasonably expects that the note is an investment, it likely expects that it will be a passive investor in the transaction without contributing to the investment beyond a monetary contribution and thus, dependent on the efforts of others for the success of the investment. This dependency is similar to the factor that the *Futura* court found important in the commercial/investment test – that of reliance by the purchaser on the efforts of the issuer.[182] Last, the family resemblance test examines whether some factor reduces the risk of the instrument, thus rendering application of the Securities Acts unnecessary.[183] Courts applying the commercial/investment test have not specifically identified this as a factor, but they have recognized that some types of notes are clearly commercial and regulated by commercial laws, not requiring additional regulation under the securities laws.[184] Thus, the four factors of the family resemblance test are similar to the factors of the commercial/investment test.

2. The Family Resemblance Test Resembles the *Howey* Test

The family resemblance test bears a strong resemblance to the *Howey*

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[178] *See supra* nn. 149-153 and accompanying text (describing the problem of "washout").

[179] *Reves*, 494 U.S. at 66.

[180] *Id.*

[181] *Id.*

[182] *Futura*, 761 F.2d at 40.

[183] *Reves*, 494 U.S. at 67.

[184] *Futura*, 761 F.2d at 39.

investment contract test.[185] Under both tests, for a security to exist: (1) there must be investment motives, rather than commercial motives, underlying the transaction;[186] (2) the investing public must reasonably believe that the instrument is being offered as an investment, and thus, with investors having a reasonable expectation of profit;[187] (3) the instrument must be capable of mass distribution or widespread trading;[188] and (4) there exists no other regulatory framework that significantly reduces the investment's risk of loss.[189]

For over fifty years, the *Howey* test has been the appropriate test for courts to use in determining whether a transaction is an "investment contract."[190] In light of the confusion surrounding the family resemblance test – a test focusing on the same considerations as the *Howey* test – it is tempting to use the *Howey* test for notes, as well. But the Supreme Court in *Reves* rejected the *Howey* test for notes, reasoning that it would be superfluous to have both "notes" and "investment contracts" included in the definition of "security" if the same test were applied to determine both.[191]

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[185] Although the Supreme Court designed and applied the test to determine whether a transaction was an investment contract, some courts had applied the test to notes, as well. *See* James D. Gordon, *Interplanetary Intelligence About Promissory Notes as Securities*, 69 Tex. L. Rev. 383, 403 (1990) (noting that the Court adopted a reformulation of the *Howey* test, and even listed the family resemblance factors in basically the same order as the prongs of the *Howey* test); Page, *supra* n. 1, at 291 (noting that it appears the Court took the elements out of the *Howey* test and turned them from elements into mere factors).

[186] The *Howey* test describes this element as "an investment of money." *Howey*, 328 U.S. at 301. The family resemblance test describes this factor as (1) the motivations of the buyer and seller, and (2) whether their motivations are commercial or investment. *Reves*, 494 U.S. at 66.

[187] The *Howey* test describes this element as the investor "is led to expect profits." *Howey*, 328 U.S. at 299. The family resemblance test describes this factor as "the reasonable expectations of the investing public." *Reves*, 494 U.S. at 66.

[188] The *Howey* test describes this element as "a common enterprise." *Howey*, 328 U.S. at 299. The family resemblance test describes this factor as the "plan of distribution" of the instrument – whether there is "common trading for speculation or investment." *Reves*, 494 U.S. at 66.

[189] Steinberg, *supra* n. 114, at 679. The Court in *Marine Bank v. Weaver* added this additional element as a modification of the *Howey* test. 455 U.S. 551, 559-560 (1982). The family resemblance test describes this factor as "the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary." *Reves*, 494 U.S. at 67 (citations omitted).

One key difference between the two tests is the expanded definition of "profit" in the family resemblance test. Under the *Howey* test, the Court limited the scope of "profit" to "capital appreciation" or "a participation in earnings." *Forman*, 421 U.S. at 852. The Court rejected "interest" as constituting profit for the "expectation of profit" element of the test. *Id.* at 855. In contrast, "'a valuable return on an investment,' which undoubtedly includes interest," is an expectation of "profit" for purposes of the family resemblance test. *Reves*, 494 U.S. at 68 n. 4. This expanded definition of "profit" has the effect of "bringing certain notes within securities law coverage that would otherwise be excluded under [the] *Howey* [test]." Steinberg, *supra* n. 114, at 679.

[190] *Howey*, 328 U.S. 293.

[191] *Reves*, 494 U.S. at 64.

But a more practical problem involves the presumption that a note is a security.

The *Howey* test has four required *elements*; the family resemblance test has four factors.[192] The Supreme Court and the lower federal courts agree that because "notes" are listed in the definition of "security" in the Securities Acts, a presumption arises that a note is a security, even though it is clear that in reality, not all notes are securities.[193]

Under the *Howey* test, a finding that a transaction is an "investment contract," and thus, a security, is a legal conclusion based on the satisfaction of four elements.[194] If all four elements are not satisfied, the transaction is not a security. Thus, the court presumes that the transaction is not a security, unless it is otherwise shown that the transaction bears all of the *Howey* characteristics of a security. Therefore, if the *Howey* test were applied to notes, the presumption would likewise be that a note is not a security unless all four elements of the *Howey* test are satisfied, rather than the appropriate presumption that a note is a security unless otherwise shown.

Alternatively, if courts retained the presumption that a note is a security when applying the *Howey* test, the issuer would have the burden of *disproving* all of the *Howey* elements. This approach, however, would not work. To illustrate, if an issuer disproved three of the four *Howey* elements, it would mean that only one element was met, which by definition of an element test[195] means that the test was not satisfied, and the note is not a security. However, the one element that the issuer failed to disprove might be highly suggestive that the note is a security. Thus, it would be unclear whether the issuer had met its burden of proving that the note is not a security.

In contrast, the four factors in the family resemblance test support the presumption that a note is a security. An issuer has the burden of proving that, based on the four factors, the note is not a security.[196] If the issuer does not meet that burden, the note is a security under the presumption. Thus, although the considerations in both tests are essentially the same, the difference between "elements" in the *Howey* test and "factors" in the family resemblance test prevents the application of the familiar *Howey* test to

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[192] Steinberg, *supra* n. 114, at 679 (reasoning that although a note will not be characterized as a security unless all four elements of the *Howey* test are satisfied, a note may be characterized as a security even if all of the factors of the family resemblance test are not met) (emphasis added).

[193] *Reves*, 494 U.S. at 65. *See supra* n. 6 (defining "security").

[194] *Howey*, 328 U.S. at 298-299.

[195] An element test requires that all elements be satisfied. The *Howey* test requires that all four elements be met; otherwise, the note is not a security. *Id.*

[196] *Reves*, 494 U.S. at 66.

notes. A more promising test is the commercial/investment test.

E. A Proposed Test

The Supreme Court believed that the framework of the family resemblance test was promising. The family resemblance test has been promising to the extent that a note in question falls squarely into the list of enumerated non-security-type notes in terms of commercial features. Beyond the list, confusion surrounds the remaining steps of the test.

The primary benefit of the family resemblance test is the enumerated list of non-security notes because many notes that are used in the everyday course of business do not have the features commonly associated with securities. This list provides some certainty to an otherwise "unpredictable" multi-factor test. It allows courts to screen out the easy cases where a note falls squarely into one of the categories of notes on the enumerated list.[197] The list also enables individuals and businesses to know quickly and easily whether a particular note is almost certainly a non-security. Therefore, this proposed test first adopts the family resemblance test's enumerated list of non-security notes.[198]

But when a note does not fall squarely into the enumerated list, the commercial/investment test provides a better multi-factor framework for analysis than the four factors of the family resemblance test because it allows a global inquiry of all relevant evidence. Because it is largely a factual inquiry, the process of deciding whether a note is a security should be open-ended to capture within the definition of "security," the "myriad financial transactions in our society that come within the coverage of [the] statutes."[199] Although the loose structures of the commercial/investment test might make predictability more difficult because it may seem that courts are making ad hoc decisions, the commercial/investment test is a common-sense test, allowing courts to do what makes sense based on all of the evidence.

Moreover, the commercial/investment test cuts to the ultimate inquiry. The result of applying this test will either be that a note is commercial, in which case it is not a security, or that the note is an investment, in which case the note is a security. No middle step is required, unlike the family

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[197] Likewise, two types of notes – bonds and debentures – are per se securities because they are specifically identified in the definition of "security" itself. 15 U.S.C. § 77b(a)(1). As long as a note has features commonly associated with bonds or debentures, it is a security.

[198] This test also adopts the well-recognized presumption that a note is a security unless the issuer can prove otherwise.

[199] *Reves*, 494 U.S. at 61 (citation omitted).

resemblance test that first requires a court to apply the four factors to determine if there is a family resemblance before concluding that the note is or is not a security.

Courts were remarkably successful at applying the commercial/investment test before *Reves*.[200] They knew, based on all the relevant evidence of a transaction, whether a note was commercial or investment. In addition, the *Reves* Court, although not adopting the commercial/investment test, recognized that the commercial/investment test and the family resemblance test were "really two ways of formulating the same general approach."[201] Thus, while choosing not to adopt the commercial/investment test, the Supreme Court did not explicitly reject the test as it did the *Howey* test.[202] Because it cuts to the ultimate inquiry and allows courts to engage in an essentially unrestricted analysis, courts should apply the commercial/investment test when a note does not squarely fall into the enumerated list of non-security notes to determine if the note is investment or commercial.

IV. CONCLUSION

Despite the Supreme Court's belief in the promise of the family resemblance test, most courts do not understand how to apply the test. For over twelve years the test has produced confusion among courts, yet the Supreme Court has not refined the test. The Supreme Court intended that the unique characteristics of the family resemblance test – the enumerated list and the four factors – would aid courts in determining if a note was a security under the circumstances of a particular transaction. In practice, many courts have utilized only the family resemblance test's list of enumerated non-security notes as a shortcut in their analyses. Many courts do not use the family resemblance test's four factors as a means to find a family resemblance to the notes on the list, but as yet another multi-factor test to determine if a note is a security. Consequently, the benefit of the family resemblance test is limited.

A more effective test would require courts to use the enumerated list of non-securities as a shortcut in their analyses when a note falls directly into one of the category of notes based on its commercial features. Where a note

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[200] Loss & Seligman, *supra* n. 52, at 936-937. In addition to the courts' inherent ability to recognize a security when they see one, the large body of case law that has developed involving the issue of whether a note is a security provides courts with many examples with which to analogize a particular note.

[201] *Reves*, 494 U.S. at 64.

[202] *Id.*

does not fall squarely into a category on the list, courts should use the commercial/investment test's factors to evaluate the determinative issue: whether or not a note is an investment, and thus, a security. Even if courts applying the family resemblance test incorrectly make a correct determination under the circumstances, this is no reason to allow a framework producing confusion to persist. The test proposed in this Comment suggests a modification that will produce clarification to courts applying the family resemblance test.