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Securities - The Paper Trail to Jail

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SECURITIES

THE PAPER TRAIL TO JAIL. *State v. Sheets*, 94 N.M. 356, 610 P.2d 760 (Ct. App.), *cert. denied*, ___N.M. ___, 615 P.2d 992 (1980).

INTRODUCTION

In *State v. Sheets*,[1] a New Mexico court for the first time construed the definition of "security" in the Securities Act of New Mexico.[2] In its opinion, the court of appeals held that the absence of the phrase "unless the context otherwise requires"[3] in the definition of "security" meant that the words "note" and "evidence of indebtedness" would be given their usual, ordinary meanings.[4] The problem with this holding is not that it resulted in the finding that Sheets' notes were securities; because of their investment characteristics they probably were securities. If read literally, however, the court's holding could extend to authorize the regulation as securities of many personal debt obligations[5] which are of a purely commercial nature and not the proper subject of the securities law. This result is undesirable

1. 94 N.M. 356, 610 P.2d 760 (Ct. App.), *cert. denied*, ___N.M. ___, 615 P.2d 992 (1980).

2. N.M. Stat. Ann. §§ 58-13-1 to -47 (1978).

3. This phrase is a very important part of the definition of securities in the majority of the federal and state case law. *See* Comment, *Commercial Notes and Definition of "Security" Under the Securities Exchange Act of 1934: A Note is a Note is a Note?*, 52 Neb. L. Rev. 478 (1973). The phrase allows a court to look beyond the form of a note to its actual substance. It is found in the federal security acts, the Uniform Securities Act, and in 45 of 52 United States jurisdictions. Of the seven jurisdictions whose statutes do not contain this phrase, two (Mississippi and New Hampshire) omit the word "note" from their statutory definition of security. Of the remaining five, New Mexico is the only one to have construed the definition of security as it relates to notes. The other states which have a definition similar to New Mexico's are Illinois, Maine, Ohio, and Utah, whose courts have yet to interpret their statutes.

4. 94 N.M. at ___, 610 P.2d at 764.

5. This casenote is concerned solely with the question of whether private personal obligation notes should be within the purview of the securities laws and will not discuss personal obligation notes issued to financial institutions. This latter type of note appears to be exempt from registration under N.M. Stat. Ann. § 58-13-30(H) (1978), which exempts

> any offer or sale to a bank, savings institution, trust company, insurance company, investment company as defined in the Investment Company Act of 1940, pension or profit-sharing trust or other financial institution or institutional buyer, or to a broker-dealer, whether the purchaser is acting for himself or in some fiduciary capacity.

and calls for judicial or legislative reconsideration of the definition of "security" to limit the *Sheets* holding.

STATEMENT OF THE CASE

Donald Sheets, in the course of financing his business, borrowed money from eight friends and acquaintances. Between October 10, 1975 and January 31, 1978, Sheets issued eighteen personal obligation notes amounting to approximately $166,000.00.[6] All of these notes carried an annual interest rate of approximately thirty-six percent,[7] were issued for a period of more than nine months, and provided that the lenders could demand full payment at any time. For issuing these notes, Sheets was arrested and charged with seven counts of selling unregistered securities.[8] At trial he was convicted on all counts and sentenced to seven three-year prison terms, to be served concurrently.[9]

COURT OF APPEALS DECISION

On appeal, Sheets argued that his notes were not securities because they were purely commercial in nature and were not investment

6. The evidence showed that Sheets borrowed money from eight individuals. Three of these people were personal friends, four were acquaintances, and one had never met Sheets prior to the transactions. All of the notes (except three which were issued to a man named Gold) were personal obligations, could be called in at any time, were not based upon the success of Sheets' business, gave no control of the money to the issuee, and carried an interest rate of approximately 36%. The notes issued to Gold were similar to the other notes except that the interest paid on them was connected to the profitability of the venture for which the money was used. Although the evidence showed that Sheets borrowed money from eight people, he was only charged on seven counts of selling unregistered securities. The reason for this discrepancy is unclear, unless the eighth person was not discovered until the time of trial, in which case the importance of adding one more count to the charge was slight. The notes were issued during a span of two-and-a-half years beginning in August of 1975 and continuing through January of 1978. Between August of 1975 and August of 1976 Sheets issued ten notes to five people. Between August of 1976 and August of 1977 he issued four notes to four people. Finally, between August of 1977 and January of 1978 he issued four notes to three people. 94 N.M. at ___, ___, 610 P.2d at 763, 769; Appellant's Brief in Chief at 3-6, Appellee's Answer Brief at Summary of Proceedings, State v. Sheets, 94 N.M. 356, 610 P.2d 760 (Ct. App.), *cert. denied*, ___N.M. ___, 615 P.2d 992 (1980).

7. In the opinion, Judge Wood said that the interest paid was 36% over the life of the note. This statement, in light of the record, appears to be erroneous. The correct percentage rate, as reflected in the briefs, trial record, and even Judge Wood's own example, was approximately 36% per year. N.M. Stat. Ann. § 56-8-11 (1978), the usury statute in force at the time Sheets borrowed his money, limits the interest rate that can be charged on an unsecured loan to 12% per annum. Interestingly, the people who issued the notes at a 36% interest rate were not charged for loaning money at higher rates than allowed by the usury laws.

8. N.M. Stat. Ann. § 58-13-4 (1978) declares: "It is a felony for any person to offer or sell any security in the state, except securities exempted or securities sold in transactions exempted, unless the security is registered by notification, by coordination or by qualification under the Securities Act of New Mexico."

9. 94 N.M. at ___, 610 P.2d at 763.

notes involving profit sharing or risk. He further argued that even if the notes were securities, they were exempt from the registration requirements under either the commercial paper[10] or isolated transaction[11] exemptions of the Securities Act. The court rejected these arguments, finding that his notes were non-exempt securities, and affirmed his conviction. In doing so, the court held that all notes, regardless of their commercial or non-commercial nature, are securities, and that the commercial paper and the isolated transaction exemptions should be construed so as to be consistent with the ordinary meanings of the statutory language.

The New Mexico Definition of Securities.

The Securities Act of New Mexico[12] defines a security as:

> *any note,* stock, treasury stock, bond, debenture, *evidence of indebtedness,* certificate of interest or participation, certificate of interest in oil, gas or other mineral rights, collateral trust certificate, preorganization certification [certificate] or subscription, transferable shares, investment contract, voting-trust certificate or *beneficial interest in title to property,* profits or earnings, or any other instrument commonly known as a security, including any guarantee of, temporary or interim certificate of interest or participation in, or warrant or right to subscribe to convert into a [or] purchase any of these.[13]

This definition is, with significant exceptions,[14] substantially the same as that contained in the Securities Act of 1933,[15] the Uniform Securities Act,[16] and the majority of blue sky laws.[17]

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10. N.M. Stat. Ann. § 58-13-29(H) (Supp. 1980). *See* text accompanying notes 33 to 40 *infra.*

11. N.M. Stat. Ann. § 58-13-30(A) (1978). *See* text accompanying notes 41 to 46 *infra.*

12. N.M. Stat. Ann. § § 58-13-1 to -47 (1978).

13. N.M. Stat. Ann. § 58-13-2(H) (1978) (emphasis added).

14. Although New Mexico's definition is similar to many other state statutes, there are several important differences. First, as discussed in note 3 *supra,* New Mexico's definition is not prefaced with the words "unless the context otherwise requires." This is a major difference and is largely responsible for the problem that this casenote addresses. *See* text accompanying notes 24 and 25. Second, New Mexico includes within its definition the phrase "beneficial interest in the title to property." This phrase has caused problems in many states because a literal interpretation of this phrase leads to the conclusion that any sale of property is a sale of a security. 50 Calif. L. Rev. 156, 159 (1962). The California legislature considered it to be such a problem that they amended their statute in 1968 to replace this phrase. Cal. Corp. Code § 25019 (West 1977). A more complete discussion of this problem can be found in R. Jennings & H. Marsh, Securities Regulations 237 (4th ed. 1977). Finally, New Mexico's definition omits the express exemption of variable annuities, which is found in most state blue sky laws. This omission could become a problem because, with a literal definition of security, insurance policies, endowment policies, or annuity contracts might be considered securities.

15. 15 U.S.C. § 77(b) (1976).

16. Uniform Securities Act § 401(1).

17. *See e.g.,* Alaska Stat. § 45.55.130(12) (Supp. 1979); Ariz. Rev. Stat. Ann. § 44-1801 (16) (Supp. 1980); Colo. Rev. Stat. § 11-51-102(12) (1973).

Sheets argued before the court of appeals that this definition, if read literally, would bring every conceivable credit transaction within the purview of the securities law.[18] He argued that such a result could not be within the contemplated scope of the Securities Act. He proposed that the court follow the federal courts' interpretations of "security" under the Securities Act of 1933 to determine which credit transactions should be considered "securities" under the New Mexico Securities Act. The United States Supreme Court has said that the term "security" "embodies a flexible rather than static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the promise of profit,"[19] and that when searching for its meaning and scope "form should be disregarded for substance and the emphasis should be on economic reality."[20]

The adoption of this principal by the federal circuit courts has led to the development of the "commercial-investment test" for determining whether a note is a security; this test is now applied by the majority of the federal courts.[21] The commercial-investment test, which considers factors such as risk, profit sharing, characterization of the note, and whether stock is normally issued,[22] "places those notes of commercial character outside the definition of security and those notes of investment character within the definition."[23] Asking

18. Sheets argued that if all notes were securities, then a person who buys his car from his brother on credit issues a security, a poker I.O.U. is a security, and a loan between friends is a security. Appellant's Brief in Chief at 12. He further argued that such a result would cause administrative chaos because the Chief of Securities is neither equipped nor expected to regulate all such transactions. *Id.*

19. Tcherepnin v. Knight, 389 U.S. 332, 338 (1967) (quoting SEC v. W. J. Howey Co., 328 U.S. 293, 299 (1946)).

20. 389 U.S. at 336 (quoting SEC v. W. J. Howey Co., 328 U.S. at 298).

21. For many years, the general view of the federal courts was that the definition of security should be read literally so as to find that almost all notes were securities. *See, e.g.*, Lehigh Valley Trust Co. v. Central Nat'l Bank of Jacksonville, 409 F.2d 989 (5th Cir. 1969). This is the view apparently adopted by the court of appeals in the *Sheets* case. In recent years, however, the federal courts have begun to look to the realities of the commercial world and the purposes of the securities laws. This has resulted in a new approach in which the courts take judicial notice that the only notes intended to be covered by the security laws are those which were sold or traded for speculative or investment purposes. They find that ordinary commercial loans which appear in the course of everyday business activity are not covered by the securities laws. *See* Zabriskie v. Lewis, 507 F.2d 546, 550-51 (10th Cir. 1974); State v. Hoephner, 574 P.2d 1079, 1081 (Okla. Crim. App. 1978).

22. *See* Comment, *Commercial Notes and Definition of "Security" Under the Securities Act of 1934: A Note is a Note is a Note?*, 52 Neb. L. Rev. 478 (1973). This article, which is cited with approval in State v. Hoephner, 574 P.2d 1079, 1081 (Okla. Crim. App. 1978), and in Zabriskie v. Lewis, 507 F.2d 546, 551 (10th Cir. 1974), sets out numerous factors as guidelines in determining whether a note should be considered a security. The author concludes that promissory notes, barring exceptional circumstances, typically should not be considered securities.

23. Zabriskie v. Lewis, 507 F.2d 546, 551 (10th Cir. 1974).

the court to apply the "commercial-investment test" to his transactions, Sheets claimed that his notes were not securities because they were purely commercial and were not investment notes involving profit sharing or risk.

The court of appeals held, however, that the commercial-investment test was inapplicable to New Mexico's definition of "security" because the federal test was based on the phrase "unless the context otherwise requires," which is not included in the New Mexico definition.[24] As support for this distinction, the court relied on dicta found in the Oklahoma case of *State v. Hoephner,*[25] which reasoned that the phrase "unless the context otherwise requires" dispensed with the need to interpret the phrase "any note" to mean *any* note.

Having declined to apply the federal test to New Mexico's Securities Act, the court of appeals looked to the New Mexico rules of statutory construction[26] and found that "[t]here is no ambiguity in the words 'note' and 'evidence of indebtedness'; their usual, ordinary meanings apply because there is no legislative intent to the contrary."[27] It is crucial to note that when Judge Wood declared that the ordinary meanings of "note" and "evidence of indebtedness" should apply, he specifically eliminated from consideration the elements of risk, profit, and profit sharing in determining whether an instrument is a security.[28] He said, in effect, that a note is a note is a note and therefore is always a security, irrespective of its commercial or investment character. As to the obligations issued by Sheets, the court held that the instruments were notes and evidences of indebtedness, and were therefore securities.

This holding, while justifiable under the *Sheets* facts, may be construed too broadly under different facts. Thus, one who borrows money on a personal obligation for a commercial purpose, such as purchasing a copying machine, without first checking to see if the notes should be registered as securities, may find himself subject to a three-year prison sentence, a $5,000 fine, or both.[29] The securities

24. 94 N.M. at ___, 610 P.2d at 765.

25. 574 P.2d 1079, 1081 (Okla. Crim. App. 1978).

26. The court looked to case law to find two basic rules of statutory construction. The first rule is found in State v. Elliot, 89 N.M. 756, 757, 557 P.2d 1105, 1106 (1977), which states: "Statutes are to be given effect as written and where free from ambiguity, there is no room for construction." The second rule is found in Tafoya v. New Mexico State Police Bd., 81 N.M. 710, 714, 472 P.2d 973, 977 (1970) which states: "There being no clearly expressed legislative intent requiring otherwise [a statutory word] is to be given its usual ordinary meaning."

27. 94 N.M. at ___, 610 P.2d at 764.

28. *Id.* at ___, 610 P.2d at 766.

29. N.M. Stat. Ann. § 58-13-43 (1978) calls for this penalty in the event of one of the security laws is broken.

laws clearly were never meant to reach this type of transaction.[30] Nevertheless, the effect of the court of appeals' decision in *Sheets* is to establish an overinclusive definition of "security" within the Securities Act.

Judge Wood indicated that this will not be a serious problem because the Act has provided exemptions for certain securities and transactions.[31] In the case of private personal obligations, two exemptions are available: the commercial paper and the isolated transaction exemptions. An examination of these exemptions will reveal, however, that they do not adequately protect the non-corporate issuer of personal obligation instruments from the effects of the court's holding in *Sheets*.[32]

The Commercial Paper Exemption

The commercial paper exemption exempts from the registration requirements

> [a]ny commercial paper which arises out of a current transaction or the proceeds of which have been, or are to be, used for current transactions, and which evidences an obligation to pay cash within nine (9) months of the date of issuance, exclusive of days of grace, or any renewal of such paper which is likewise limited, or guarantee of such paper or of any such renewal.[33]

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30. The purpose of the securities laws is generally held to be the protection of the public from various methods of deceit and fraud in the sales of securities, not the regulation of commercial transactions. *See* McClure v. First Nat'l Bank, 352 F. Supp. 454 (N.D. Tex. 1973); McElfresh v. State, 151 Fla. 140, 9 So. 2d 277 (1942).

31. 94 N.M. at ____, 610 P.2d at 766.

32. N.M. Stat. Ann. § 58-13-30(J) (1978) and N.M. Stat. Ann. § 58-13-31 (Supp. 1980) provide added protection for the corporate issuer beyond that available to the non-corporate issuer. Section 58-13-30(J) provides for the exemption to the registration requirements for:

> the issuance and sale by any corporation organized under the laws of this state of its securities at a time when the number of security holders does not, and will not in consequence of the sale, exceed twenty-five and:
>
> (1) the seller reasonably believes that all buyers are purchasing for investment; and
>
> (2) no commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer.

However, this protection is limited by section 58-13-31 which in part requires that

> any corporation organized under the laws of this state claiming the exemption afforded by subsection J of Section 58-13-30 NMSA 1978, at the time when, in consequence of a sale under such exemption, the number of security holders would exceed three, shall give notice in a form prescribed by the commissioner of its intention to avail itself of the exemption prior to any additional offers or sales.

As a consequence of section 58-13-30(J), a corporate issuer is given greater protection than the non-corporate issuer. Interestingly, had Sheets been incorporated and complied with the notification requirements of subsection J, there would have been no crime.

33. N.M. Stat. Ann. § 58-13-29(H) (Supp. 1980).

Three criteria must therefore be met for a note to be exempt. First, the note must be commercial paper. In attempting to define commercial paper, both the State and Sheets offered special definitions.[34] The court refused, however, to accept any special definition, concluding that there was "nothing indicating the New Mexico Legislature intended a special meaning" and therefore "the ordinary meaning of 'commercial paper' applies."[35] The court found it unnecessary to define commercial paper specifically, but said that "commercial paper" is a flexible term "descriptive of the kind of paper and not of the mode in which it was issued or used in a particular situation."[36] Furthermore, the court added that the ordinary meaning encompasses all promissory notes, including those issued by Sheets.[37]

The second requirement to be met under the commercial paper exemption is that a note must be used for current transactions. Generally, "current transactions" have been described as those transactions

> which are to be used in producing, purchasing, carrying or marketing goods or in meeting current operating expenses of a commercial, agricultural or industrial business, and which [are] not to be used for permanent or fixed investment, such as land, buildings, or machinery, nor for speculative transactions or transactions in securities.[38]

The court of appeals, however, did not reach the issue of what constitutes a current transaction in New Mexico because Sheets failed to meet the final requirement for this exemption.

The final requirement of the commercial paper exemption is that the note must evidence "an obligation to pay cash within nine months of the date of issuance."[39] This requirement is self-explanatory and

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34. The State argued that the federal definition of commercial paper applied. This definition limits the term "commercial paper" to only prime quality negotiable commercial paper of the type available for discount at the Federal Reserve Bank and which is rarely bought by private investors. This definition is the same as those recited in Sanders v. John Nueveen & Co., 463 F.2d 1075 (7th Cir. 1972); People v. Dempster, 396 Mich. 700, 242 N.W.2d 381 (1976); SEC Release No. 33-4412, 26 Fed. Reg. 9158 (1961). The application of this definition, however, was rejected by the court because it was based upon federal legislative history which is not found in New Mexico's definition of a security. 94 N.M. at ___, 610 P.2d at 768.

Sheets also argued for the adoption of a special definition. He maintained that the U.C.C. definition applied. The court rejected this argument, noting that the purpose of the U.C.C. was to simplify, clarify, and modernize the law governing commercial transactions, while the purpose of the Securities Act is to prevent the sale of unregistered securities. The court of appeals then concluded that because the purposes of the two statutes are different, one could not say that the meanings of "commercial paper" must be defined the same. *Id.*

35. 94 N.M. at ___, 610 P.2d at 768.

36. *Id.* at ___, 610 P.2d at 767.

37. *Id.*

38. SEC Release No. 33-4412, 26 Fed. Reg. 9158 (1961).

39. N.M. Stat. Ann. § 58-13-29(H) (Supp. 1980).

the court applied the ordinary meaning test, interpreting it to mean "an obligation for payment in full within nine months of the date of issuance."[40] Since Sheets' notes were all issued for longer than nine months, the court denied him this exemption.

The fairly strict requirements of the commercial paper exemption apparently limit this exemption to those notes which are issued for short term obligations to finance variable costs of a company. The commercial paper exemption provides no protection to one whose notes are issued for more than nine months or are used to buy durables. Any protection for notes of this type, therefore, must come under the isolated transaction exemption.

Isolated Transaction Exemption

The isolated transaction exemption applies to "any isolated transaction, whether effected through a broker or not."[41] The court in *Sheets,* following the majority view,[42] interpreted this exemption to apply only to those transactions which are "unique; occurring alone or at once; sporadic, not likely to recur."[43] Applying this interpretation to the notes issued by Sheets, the court held that the eighteen notes issued to eight individuals over a course of two-and-a-half years were neither unique nor sporadic, and denied Sheets this exemption.[44] Because the court construed this exemption so narrowly,[45]

40. 94 N.M. at ___, 610 P.2d at 768.

41. N.M. Stat. Ann. § 58-13-30(A) (1978). New Mexico's isolated transaction exemption is different from many statutes of its kind. First, it is available to issuers as well as non-issuers. The majority of exemptions of this kind are available only to non-issuers. *See* [1979-80] 1 Blue Sky L. Rep. (CCH) ¶ ¶ 2121, 2131. The effect of this difference is discussed in Parnall & Ticer, *A Survey of the Securities Act of New Mexico,* 2 N.M.L. Rev. 1, 37-38 (1972). Second, New Mexico's exemption makes no distinction between a private offering and a public offering. Most jurisdictions grant this exemption only for private offerings. In his brief, Sheets asked the court to find that the public/private offering distinction is implicit in the isolated transaction exemption. The court, citing Anderson v. Mikel Drilling, 257 Minn. 487, 102 N.W.2d 293 (1960), rejected this argument, stating that the two exemptions serve different purposes and rest on substantially different considerations. When reading the court's discussion of this argument, one should note that when Judge Wood refers to the "public offering exemption" he is actually discussing what is known as the "private offering" exemption.

42. Annot., 1 A.L.R.3d 614 (1965).

43. 94 N.M. at ___, 610 P.2d at 769.

44. For support of the court's reasoning, see the breakdown of Sheets' transactions, *supra* note 6.

45. It should be noted that because of a notification requirement in force at the time Sheets issued his notes, the isolated transaction exemption was even narrower than the court's decision indicates. The pre-amendment provision, N.M. Stat. Ann. § 48-18-22.1 (1953) (current version at N.M. Stat. Ann. § 58-13-21 (Supp. 1980)), required that to qualify for the isolated transaction exemption one must notify the Chief of the Securities Bureau of the Financial Institutions Division of the Commerce and Industry Department prior to the issuance of the security. The New Mexico Legislature in 1978, however, abolished the notification requirement for this exemption, thus making the isolated transaction exemption a little broader. 1978 N.M. Laws, ch. 12, § 1.

it appears that it is of no practical use to those individuals who must borrow money from several sources, rather than from one source.[46]

CONCLUSION

Given the limited scope of the commercial paper and isolated transaction exemptions in the New Mexico securities law, the court of appeals' holding in *Sheets* has created an undesirable situation. A person who borrows money from several friends to purchase inventory, furniture, and equipment for his business may find himself arrested for selling unregistered securities. Because of the broad language in *Sheets* to the effect that all notes are securities, this activity, though probably purely commercial in nature, may subject the borrower to the criminal penalties of the securities laws. Surely such a result was intended neither by the legislature nor by the court of appeals; rather, they sought to penalize those engaging in transactions, similar to Sheets', in which the notes issued could be characterized more as investments than as commercial loans.

Nevertheless, the above example makes it clear that the court's holding, in which all notes and evidences of indebtedness are defined as securities, has created a potentially dangerous and inequitable situation. This approach to the definition of "security" must be changed to avoid potential inequities and to protect individuals making simple commercial credit transactions from the criminal sanctions of the securities law.

There are two possible remedies. The judiciary could withdraw from the overly broad holding in *Sheets,* and distinguish between those notes having a commercial character and those having an investment character. This distinction would recognize the realities of the commercial world and the true purposes of the Act. The alternative, should the judiciary feel constrained by the clear and unambiguous language found in New Mexico's statutory definition of "security," is legislative action. While legislative tinkering with securities law should not be undertaken lightly, judicial inaction would warrant amending the Securities Act to alleviate this problem. To give adequate protection to issuers of ordinary commercial notes, the amendment would have to add the prefatory language "unless the context otherwise requires" to the definition of "security." With this language, the courts would be free to follow the majority view on the

46. Because private sources are often limited in their funds, the average borrower in the private market frequently must go to more than one source to obtain sufficient funds for his needs. This fact leads to the conclusion that the isolated transaction exemption is a narrow exemption which apparently is available only to those who can obtain funds from a single source; this exemption is of no protection for the individual who borrows money in small loans from many friends.

definition of a security, and to distinguish between commercial and investment notes. Meanwhile, until some action is taken, all issuers of private personal obligation notes should be warned and made aware of the paper trail to jail.

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