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Marine Bank v. Weaver: New Guidance On What Is Not A Security

By M. Thomas Arnold

INTRODUCTION

The United States Supreme Court recently decided *Marine Bank v Weaver*,¹ involving the definition of a "security" for purposes of §10 (b) of the Securities Exchange Act of 1934.² While the opinion is reasonably brief,³ the case may aid lawyers in determining whether a particular transaction involves a security.⁴

This article includes a discussion of the definition of the term "security" in various securities laws, the *Howey* test, two prior Supreme Court decisions, and the *Marine Bank* case, which is summarized and commented upon. The significance of *Marine Bank* lies in its focus on the language preceding and overriding the statutory definition of a "security" if "the context otherwise requires." The case puts some meat on the bones of this skeletal language.

I. THE SIMILARITY OF THE STATUTORY DEFINITIONS OF "SECURITY"

The definitions of "security" found in the Securities Act of 1933⁵ and the Securities Exchange Act of 1934⁶ are very similar. Thus, any interpretation of the term under the Securities Exchange Act of 1934 carries substantial weight in interpreting the term for Securities Act of 1933 purposes, and vice versa.⁷ In addition, the definitions of "security" under these two federal laws are similar to the definition found in the Uniform Securities Act.⁸ This is not coincidental.⁹

In sum, "[w]hile there are some differences, the basic definition of a security under the Securities Act, the Exchange Act, and state blue sky laws is the same."¹⁰

II. THE HOWEY TEST

The term "security" has long been accorded a broad interpretation under both federal and state securities laws. In particular, the catch-all phrase "investment contract," found in the definition of securities under all these laws, has been utilized to fulfill the remedial purposes of the acts. The Supreme Court has stated that

the reach of the [Securities Act] does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts,' or as 'any interest or instrument commonly known as a "security."'¹¹

In the landmark Supreme Court case of *S.E.C. v. W. J. Howey Co.*¹² the now famous *Howey* test was born. The test, according to the Court, "is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."¹³

State courts, as well as federal courts, have looked to the *Howey* test in determining whether a particular interest constituted a security.¹⁴ Along

the way, several questions of interpretation have arisen. For example, the *Howey* test speaks of profits coming solely from the efforts of others. Read literally, this test would exclude an interest in any venture in which the investor's efforts contributed—such as a franchise. Recognizing this, a number of decisions have held that “solely” does not really mean “solely.” The best known decision in this respect is *S.E.C. v Glenn W. Turner Enterprises*,¹⁵ where the Ninth Circuit held that “the word ‘solely’ should not be read as a strict or literal limitation on the definition of an investment contract.”¹⁶ The Court realized that if the requirement were read in a mechanical fashion, “[i]t would be easy to evade by adding a requirement that the buyer contribute a modicum of effort.”¹⁷ The Court felt that the remedial aims of the securities laws could be best served by adopting a “more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”¹⁸

Another question of interpretation has involved the meaning of the “common enterprise” requirement. Some courts have interpreted commonality to require the existence of multiple investors and a pro rata sharing of profits.¹⁹ Other courts have rejected the need for this horizontal commonality.²⁰ Instead, these courts have viewed the common enterprise requirement as meaning nothing more than the intertwining of the fortunes of the investor with the efforts and successes of either those seeking the investment (the promoter) or of third parties (other investors).²¹ This approach accepts either horizontal or vertical commonality as sufficient. Obviously, this approach is more inclusive than the first.

Thus, the *Howey* test has provided a basic framework for the determination of whether a transaction involves a security. Questions of its interpretation have arisen which have generally been resolved through analysis of the purposes of the securities laws.

III. RECENT SUPREME COURT CASES FINDING NO SECURITY

In recent years, the Supreme Court has considered several cases involving the issue of what is

a security. In *United Housing Foundation, Inc. v Forman*,²² the Court decided that shares of stock entitling a purchaser of the shares to lease an apartment in a non-profit housing cooperative were not securities. The shares of stock were non-transferable and could descend only to a surviving spouse. The Court rejected the notion that the purchased interest must be considered a “security” because it was represented by “stock” and because the statutory definition includes the word “stock.”²³ The Court stated that “[b]ecause securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto.”²⁴ The Court pointed out that the shares involved had none of the characteristics commonly associated with a security in the commercial world.²⁵

The Court also rejected the idea that a share of stock in the cooperative constituted an “investment contract.” The Court stated that “there can be no doubt that investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments.”²⁶

In *International Brotherhood of Teamsters v Daniel*²⁷ the Supreme Court decided that a compulsory, noncontributory pension plan did not constitute a “security” under the federal securities laws. The Court stated that the test of whether a financial relationship constitutes an “investment contract” is the *Howey* test.²⁸ The Court continued, however, saying that “[t]his test is to be applied in light of ‘the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties.’”²⁹

Applying the *Howey* test to the facts of the case, the Court held, first, that there was no investment of money³⁰ and, second, that there was no expectation of profits from a common enterprise.³¹ The Court rejected the plaintiff-employee's argument that he had invested in the pension fund by allowing part of his compensation to be paid into it. The Court held that “the purported investment [was] a relatively insignificant part of an employee's total and indivisible compensation package”³² and that the “decision to accept and retain covered employment must have only an attenuated relationship, if any, to perceived investment possibilities of a future pension.”³³

The Court also found that the eligibility of an employee for a pension under the plan in question depended primarily on the employee's efforts to meet the vesting requirements.³⁴ Thus, any "profit" expected by an employee would be one based primarily on his or her own efforts rather than on the managerial efforts of the trustee.³⁵

After proceeding through the *Howey* type analysis, the Court turned, in Part IV of the opinion,³⁶ to an additional consideration. In this part of the opinion, the Court noted the passage of the Employee Retirement Security Act of 1974 and discussed briefly the thrust of this legislation. It then stated:

The existence of this comprehensive legislation governing the use and terms of employee pension plans severely undercuts all arguments for extending the Securities Acts to noncontributory, compulsory pension plans. Congress believed that it was filling a regulatory void when it enacted ERISA Not only is the extension of the Securities Acts by the court below unsupported by the language and history of these Acts, but in light of ERISA it serves no general purpose.³⁷

This theme, introduced as something of an afterthought, was to reappear in the *Marine Bank* opinion.

IV. MARINE BANK V. WEAVER: A BRIEF SUMMARY

*Marine Bank v. Weaver*³⁸ involved a couple who purchased a \$50,000 certificate of deposit from a bank. They then pledged the certificate, which was partially insured by the Federal Deposit Insurance Corporation, to the same bank to guarantee a \$65,000 loan by the bank to a third party. The *quid pro quo* for the loan guarantee was an agreement between the owners of the certificate and the third parties whereby the certificate owners were to receive 50 per cent of the net profits of the third parties' business and \$100 per month for the duration of the guarantee. In addition, the certificate owners were given the right to veto future borrowing by the business, and were given the use, at the discretion of the third parties, of a barn and pasture owned by the business.³⁹

The business eventually went bankrupt, and the bank indicated its intent to claim the pledged certificate of deposit. The certificate owners thereupon sued the bank alleging, *inter alia*, a violation of Securities Exchange Act §10 (b). They alleged that the bank officers had represented that the proceeds of the loan they were guaranteeing would be used by the business as working capital. Instead, the money was allegedly used in large part to repay prior bank loans and cover an overdrawn checking account. Additionally, it was alleged that the bank officers were aware of but did not disclose the business' poor financial condition.⁴⁰

The District Court entered summary judgment for the bank on the §10 (b) claim on the basis that "if a wrong occurred it did not take place 'in connection with the purchase or sale of any security,' as required for liability under §10 (b)."⁴¹ The Court of Appeals reversed, holding that either the certificate of deposit or the contract between the certificate owners and the third parties could reasonably be found by a fact finder to be a security.⁴²

The Supreme Court reversed the Court of Appeals. While recognizing that the definition of "security" under the Securities Exchange Act of 1934 is broad and that the term has been interpreted in an expansive manner, the Court stated:

The broad statutory definition is preceded, however, by the statement that the terms mentioned are not to be considered securities if 'the context otherwise requires ' Moreover, we are satisfied that Congress, in enacting securities laws, did not intend to provide a broad federal remedy for all fraud.⁴³

The Court held, first, that the certificate of deposit was not a security. According to the Court, bank certificates of deposit are significantly different from other long-term debt obligations. The certificate of deposit in question "was issued by a federally regulated bank which is subject to the comprehensive set of regulations governing the bank industry."⁴⁴ The Court went on to note that "deposits [in federally regulated banks] are insured by the Federal Deposit Insurance Corporation. Since its formation in 1933, nearly all depositors in failing banks insured by FDIC have received payment in full, even payment for the portions of their deposits above the



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amount insured."⁴⁵ These considerations led the Court to conclude:

The definition of security in the 1934 Act provides that an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the context otherwise requires. It is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws since the holders of bank certificates of deposit are abundantly protected under the federal banking laws. We therefore hold that the certificate of deposit [involved] is not a security.⁴⁶

The Court also held that the agreement between the certificate holders and the third parties was not a security. It felt that the agreement was "not the type of instrument that comes to mind when the term security is used" ⁴⁷ According to the Court:

The unusual instruments found to constitute securities in prior cases involved offers to a number of potential investors, not a private transaction as in this case. In *Howey*, for example, 42 persons purchased interests in a citrus grove during a four-month period. In *C. M. Joiner Leasing*, offers to sell oil leases were sent to over 1,000 prospects. In *C. M. Joiner Leasing*, we noted that a security is an instrument in which there is 'common trading.' The instruments involved in *C. M. Joiner Leasing* and *Howey* had equivalent values to most persons and could have been publically traded.⁴⁸

By comparison, the certificate of deposit owners and the third parties had negotiated one-on-one a unique agreement "not designed to be traded publically."⁴⁹

The Court's holding in *Marine Bank v Weaver*, however, was expressly limited by the Court to the facts of the case. The final footnote to the opinion stated:

It does not follow a certificate of deposit or business agreement between transacting parties invariably falls outside the definition of a security as defined by the federal statutes. Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.⁵⁰

V. MARINE BANK V. WEAVER: SOME COMMENTS

The decision in *Marine Bank v Weaver* is interesting in several respects. First, while the Court mentioned the *Howey* case, it abstained from a *Howey* type analysis as to the certificate of deposit's status. Instead, it focused primarily on the perceived lack of need for application of the antifraud provisions of the federal securities laws. What makes this intriguing is that a number of past lower federal court and state court decisions can perhaps be best explained as attempts to use the securities laws to fashion remedies where other remedies may have been inadequate or unavailable.⁵¹

Marine Bank can be viewed as the negative image of these cases. It denied application of the securities laws because other federal remedies and safeguards were deemed adequate. The Court's approach is reminiscent of Part IV of the *Daniel* opinion, which the Court discussed in a footnote to *Marine Bank v Weaver*.⁵² In *Daniel*, however, the Court spoke of the lack of need for application of the federal securities laws only after applying the *Howey* test to the facts of the case.

Second, the Court indicated that the scope of the federal securities laws is limited to those frauds involving instruments having "equivalent values to all persons"⁵³ and the ability to be "traded publically."⁵⁴ The phraseology "equivalent values" seems to connote some readily ascertainable value which would facilitate trading of the interest.

Accordingly, the Court refused to apply the federal securities laws to a "unique agreement, negotiated one-on-one by the parties."⁵⁵ Thus, while the Court reaffirmed the applicability of the antifraud provisions of the federal securities laws to "uncommon and irregular instruments,"⁵⁶ it seems willing to leave parties to unusual, negotiated transactions to their remedies, if any, under other laws.

CONCLUSION

The *Marine Bank* case will undoubtedly be useful to attorneys in assessing potential remedies for a foregone set of facts, as well as in evaluating and structuring contemplated transactions. It provides some feeling for those contexts which may be viewed by the Supreme Court as inappropriate for application of the antifraud provisions of the federal securities laws. These would likely include transactions which are closely and more directly regulated by other provisions of federal law and unique, privately-negotiated agreements, interests in which are not amenable to public trading.

1. 102 S. Ct. 1220, 71 L. Ed. 2d 409, 50 U.S.L.W. 4285 (March 8, 1982).

2. 15 U.S.C.A. §78j (b) (1981).

3. No double-entendre intended.

4. "The failure to recognize that a security was involved in a particular transaction has been the focus of a significant amount of litigation." Smith, "Preventing Legal Malpractice" 93 (1981).

5. §2 (1) of the Securities Act of 1933, 15 U.S.C.A. §77b (1) (1981).

6. §3 (a) (10) of the Securities Exchange Act of 1934, 15 U.S.C.A. §78c (a) (10) (1981).

7. *Marine Bank v Weaver*, 102 S. Ct. 1220, 1223 n. 3 (1982) ("We have consistently held that the definition of security in the 1934 Act is essentially the same as the definition of security in §2 (1) of the Securities Act of 1933, 15 U.S.C. §77b (1)."); *Tcherepnin v Knight*, 389 U. S. 332, 335-6 (1967) ("The Securities Act of 1933 . . . contains a definition of security virtually identical to that contained in the 1934 Act. Consequently, we are aided in our task by our prior decisions which have considered the meaning of security under the 1933 ACT.")

8. §401 (1) of the Uniform Securities Act.

9. The Commissioners' Note to §401 (1) of the Uniform Securities Act indicates that it is based on §2 (1) of the Securities Act of 1933. 7A U.L.A. 631 (1978).

10. Bloomenthal, "1981 Securities Law Handbook" 18.

11. *S.E.C. v C. M. Joiner Leasing Corp.*, 320 U. S. 344, 351 (1943).

12. 328 U. S. 293 (1946).

13. 328 U. S. 293, 301 (1946).

14. See, e.g., *Rose v Dobras*, 624 P2d 887 (Ariz. App. 1981). "Case applications of the *Howey* definition at both the state and federal levels are legion." Rapp, "The Role of Promotional Characteristics in Determining the Existence of a Security," 9 Sec. Reg. L. J. 26, 27 (1981).

15. 474 F2d 476 (9th Cir. 1973).

16. 474 F2d at 482.

17. *Id.*

18. *Id.*

19. See, e.g., *Hirk v Agri-Research Council, Inc.*, 561 F2d 96, 99-102 (7th Cir. 1977).

20. "There are two schools of thought as to what constitutes a common enterprise. One emphasizes the economic interest between the promoter and the investor and is called the vertical approach. The other emphasizes the economic interest among the investors and is called the horizontal approach." (Footnotes omitted.) Note, 8 Florida St. L. Rev. 129, 132 (1980).

21. See, e.g., *S.E.C. v Continental Commodities Corp.*, 497 F2d 516; 521-2 (5th Cir. 1974).

22. 421 U. S. 837 (1975).

23. 421 U. S. at 848.

24. 421 U. S. at 849. Still "[a] share of stock will almost always be deemed to be a 'security'." Ratner, "Securities Regulation In A Nutshell" 23 (1978).

25. 421 U. S. at 851.

26. 421 U. S. at 853.

27. 439 U. S. 551 (1979).

28. 439 U. S. at 558.

29. *Id.*, quoting from: *United Housing Foundation, Inc. v Forman*, 421 U. S. 837, 851-2 (1975).

30. 439 U. S. at 559-61.

31. 439 U. S. at 561-2.

32. 439 U. S. at 560.

33. *Id.*

34. 439 U. S. at 562.

35. *Id.*

36. 439 U. S. at 569-70.

37. *Id.*

38. 102 S. Ct. 1220 (1982).

39. 102 S. Ct. at 1222.

40. *Id.*
41. *Id.*
42. 102 S. Ct. at 1222-3.
43. 102 S. Ct. at 1223.
44. 102 S. Ct. at 1224.
45. *Id.*
46. 102 S. Ct. at 1225. The Court's comments were made prior to the collapse of the Penn Square Bank. The adequacy of federal oversight and regulation under federal banking laws has been questioned as a result of the Penn Square failure. See *Tulsa World*, July 16, 1982, Section D, at 2, col. 1. In addition, the amount of uninsured deposits at Penn Square has been estimated to be \$250 million. *Wall Street Journal*, July 16, 1982, at 17, col. 3 (S.W. ed.). The holders of these deposits may lose over 20 percent of their principal. *Wall Street Journal*, July 9, 1982, at 18, col. 5 (S.W. ed.).
47. 102 S. Ct. at 1225.
48. *Id.* [citations omitted].
49. *Id.*
50. 102 S.Ct. at 1225-6 n.11.
51. Cf. Ratner, "Securities Regulation In A Nutshell" 25 (1978):
These terms ["investment contract" and "certificate of interest or participation in any profit-sharing agreement"] have been liberally interpreted by the courts to apply to a wide range of schemes, particularly where the SEC or state regulators have sought injunctions against activities for which there was no prompt effective relief available under other laws designed to protect the public.
52. 102 S. Ct. at 1224 n. 7.
53. 102 S. Ct. at 1225.
54. *Id.*
55. *Id.*
56. 102 S. Ct. at 1223.