

## *When Is a Promissory Note a Security? Bruce E. Methven*

Many clients want to know whether their promissory notes are securities. If they are securities, then the securities laws procedures have to be followed when the notes are issued. If they are not securities, then there is no need for securities disclosures or filings. Unfortunately, promissory notes are usually securities, although there are exceptions.

A few things can be said with certainty. If the notes are convertible into equity (stock, LLC ownership, etc.) then they are securities. In addition if the notes contain any share of profits in addition to interest, the notes are securities.

### **Federal Law**

Still, even interest-only notes frequently constitute securities. Federal law (which basically applies if a note is sold across state lines) in this area is complex.

The key case is a U.S. Supreme Court case, *Reves v. Ernst & Young*, 110 S. Ct. 945 (1990). The case starts with a rebuttable presumption that any note with a maturity in excess of nine months is a security. On the other hand, if a loan bears a close enough “family resemblance” to a list of seven specific types of loans, then it’s not a security. One of these is a note secured by a lien on a business or some of its assets, though one has the feeling that this is directed at bank loans and factoring.

In addition to the list of specific loans that generally are exempt, the Court instituted a four-factor test to determine if a note is a security. The first factor is whether the loan money will be used for investment or for operating expenses. The second factor is whether the offer is to a number of investors or a unique agreement negotiated one on one. The third factor is, believe it or not, whether the investing public would reasonably consider the arrangement to be a security. Obviously that’s highly subjective, although the Court mentioned the question may be whether the arrangement has the character of an investment. The fourth one is whether there is some factor, that significantly reduces the risk of the investment. In this regard the Court mentions collateral and insurance as risk reducers.

Often it seems that the key factor is often whether there are multiple lenders or just one.

### **California Law**

To make matters more complicated, states have their own rules for determining whether a promissory note is a security. On the positive side, those rules are often much more clear.

California law will be used as an example. For only California’s rules to apply (and not federal rules) all investors must be in California, and the borrower must be a California entity with its principal place of business in California and more than half its revenues come from California.

Again, if a California promissory note has any kind of profit participation, an equity “kicker” or the right to be converted into equity, it’s definitely a security.

In addition, under California law, a promissory note secured by fractionalized interests is a security. A note is fractionalized if either 1) multiple investors are investing in the same promissory note or 2) multiple investors, even if they have separate promissory notes, are secured by the same collateral and the notes do not have different levels of seniority.

If it’s not a fractionalized note, then it will still be a security if it is not adequately secured -- unless the investor actually takes an active part in management and has the ability to do so. (A right to participate in management is not enough if it’s not adequately exercised.) Adequate security means the collateral must be sufficient to cover the note plus interest plus at least a bit of a cushion; otherwise the notes are still securities.

So, at least under California law, basically the only promissory note that is not a security is one that provides interest only (no profit participation or conversion to equity), is fully secured and is given only to a single investor who has his/her own individual level of seniority in the security. The securities laws apply to other promissory notes in the same way that the securities laws apply to stock.

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For more information on securities laws, head to Background on the Securities Laws: [http://thecaliforniasecuritiesattorneys.com/?page\\_id=41](http://thecaliforniasecuritiesattorneys.com/?page_id=41)

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