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# Applicability of Rule 10b-5 to Pledges of Securities

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# Applicability of Rule 10b-5 to Pledges of Securities

Section 10(b) of the Securities Exchange Act of 1934[1] and rule 10b-5[2] promulgated thereunder have been interpreted to provide a civil remedy for fraud alleged "in connection with the purchase or sale of any security."[3] The allegedly fraudulent transaction thus must be characterized as a "sale" to fall within the purview of rule 10b-5.[4] The pledge of securities[5] in consideration for a loan, however, has proven to

1. Section 10(b) provides in pertinent part that it shall be unlawful "to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . ." 15 U.S.C. § 78j(b) (1976).

2. It shall be unlawful for any person . . .
(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of dealing which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1979).

3. Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952); *accord*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731 (1975). Some commentators have suggested that the *Birnbaum* rule unreasonably prevented recovery of damages actually caused by rule 10b-5 violations. *See, e.g.*, Lowenfels, *The Demise of the* Birnbaum *Doctrine: A New Era for 10b-5*, 54 VA. L. REV. 268 (1968).

4. The Act offers no comprehensive definition of either "purchase" or "sale," providing rather that "purchase" "include[s] any contract to buy, purchase, or otherwise acquire," and that "sale" "include[s] any contract to sell or otherwise dispose of." Securities Exchange Act of 1934, ch. 404, § 3(a)(13), (14), 48 Stat. 881 (codified at 15 U.S.C. § 78c(a)(13), (14) (1976)). Throughout this Comment, the "purchase" or "sale" requirement will be treated as if "sale" alone were considered, since a "purchase" will occur with every "sale."

Courts have applied the term "sale" to a variety of transactions. SEC v. National Sec., Inc., 393 U.S. 453 (1969) (exchange of securities in merger and consolidation); Coffee v. Permian Corp., 434 F.2d 383 (5th Cir. 1970) (stockholder deemed seller when liquidation of corporate assets converted stock into claim for cash), *cert. denied*, 412 U.S. 920 (1973); Rekant v. Desser, 425 F.2d 872 (5th Cir. 1970) (issuance of a corporation's own security a sale); Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (en banc) (same), *cert. denied*, 395 U.S. 906 (1969); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960) (issuance in exchange for spurious assets), *cert. denied*, 365 U.S. 814 (1961). *But cf.* Sacks v. Reynolds Sec., Inc., 593 F.2d 1234 (D.C. Cir. 1978) (custodial transfer while legal title unchanged *not* a sale); International Controls Corp. v. Vesco, 490 F.2d 1334 (2d Cir.) (transfer of security from subsidiary to second wholly owned corporation *not* a sale), *cert. denied*, 417 U.S. 932 (1974).

5. An investor holding a portfolio of securities "pledges" the securities to obtain from a lender the use of a portion of their cash value, while retaining an interest in the securities to benefit from appreciation. The pledge allows the lender to sell the securities in satisfaction of the loan upon default.

Throughout this Comment, the term "securities pledged" refers to stocks, bonds, and other instruments which conform to the statutory definition of "security," 15 U.S.C. § 78c(a)(10) (1977).

be a difficult transaction to classify for regulatory purposes. In a pledge transaction, the pledgor retains both title and various incidents of share ownership, while the pledgee receives possession of the share certificates and other incidents of ownership.[6]

Circuits have split on the appropriate treatment of pledges under rule 10b-5. The Second Circuit has held that pledges of securities are sales because the risk of investment in the securities passes to the lender.[7] While conceding that some pledges of securities theoretically may qualify, the Fifth Circuit has held that ordinary pledges of securities are not "sales."[8] The Supreme Court recently declined to resolve this conflict by dismissing certiorari in *Bankers Trust Company v. Mallis*.[9]

Since a high proportion of loans by institutions and private persons are collateralized by pledged securities, this commercially important issue requires authoritative resolution. The Second Circuit's "sale" characterization of pledges, engendering both underwriter status and potential fraud liability, has provoked marked and continuing anx-

"Pledgor" will be used to signify one who retains title and makes a pledge of securities in partial consideration for a loan to himself or another. Within the class of pledgors the term "guarantor" will refer to the party whose pledge guarantees another's repayment of a loan. "Pledgee" will signify the party that accepts a pledge of securities in partial consideration for making a loan, thereby acquiring possession without title. "Issuer" will refer to the corporation whose securities are the subject of the pledge transaction.

6. At common law, a security interest in a pledge is perfected when the secured party acquires possession of the collateral. Legal title, however, remains in the pledgor. Usually a pledgor may sell the stock subject to the security interest, vote the stock, receive dividends, and remain liable for any ad valorem tax. The pledgee has "no general property right in the thing pledged, but only a right, upon default, to sell in satisfaction of the pledgor's obligations," Pauly v. State Loan & Trust Co., 165 U.S. 606, 622 (1897). *See generally* L. JONES, COLLATERAL SECURITIES AND PLEDGES §§ 1, 176a, 441, 602 (3d ed. 1912), *cited in* National Bank of Commerce v. All Am. Assurance Co., 583 F.2d 1295, 1300 (5th Cir. 1978). *See also* note 44 *infra*.

Article 9 of the Uniform Commercial Code has codified the law of security interests in stock certificates. U.C.C. § 1-201 (37) defines "security interest" as an interest in personal property or fixtures that secures payment or performance of an obligation. U.C.C. § 1-201(32) specifically includes a pledge in the definition of "purchase." The Official Comment to U.C.C. § 9-101 states that "the Article applies to all transactions intended to create a security interest in personal property and fixtures."

Article 9 provides for perfection of a security interest in stock certificates by possession, without filing to register such interest. U.C.C. § 9-305. Upon default the debtor may redeem a security by tendering fulfillment of the obligations secured, U.C.C. § 9-506, or the secured party may sell the collateral, apply net proceeds in satisfaction of the indebtedness, U.C.C. § 9-504(1), and account to the debtor for any surplus. U.C.C. § 9-502(2).

7. Mallis v. FDIC, 568 F.2d 824, 829 (2d Cir.), *cert. granted sub nom.* Bankers Trust Co. v. Mallis, 431 U.S. 928 (1977), *cert. dismissed*, 435 U.S. 381 (1978).

8. McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974) *cert. denied*, 420 U.S. 930 (1975). *See* text accompanying notes 27-52 *infra*.

9. 435 U.S. 381 (1978) (per curiam). The Court had recognized the importance of the issue by initially granting certiorari, but the case proved to be an inapt vehicle for resolving the matter after a crucial concession was made at oral argument. *See* text accompanying notes 53-60 *infra*. The question thus remains open.

iety in the business community.[10] Additionally, the greater transaction costs occasioned by the sometimes problematic disclosure requirements of rule 10b-5 in order to avoid material omissions or misrepresentations may result in fewer marginally efficient loans on pledged securities. Uniformity of treatment by the circuits could relieve or neutralize much of the tension created by the current doctrinal discrepancies.

This Comment proposes to resolve this conflict by characterizing only those pledges that shift the investment risk of the declining market price for the securities from the borrower to the lender as rule 10b-5 "sales." Pledges that do not so shift risk—occurring when the lender has recourse to other assets of the borrower sufficient to satisfy the note obligation—would not be classified as "sales" under this approach. This test would ensure that rule 10b-5 liability reaches ouly those transactions in which the lender makes a securities "investment" in economic reality. While this formulation incorporates the Second Circuit's risk rationale, it takes issue with the Second Circuit's apparent extension of rule 10b-5 liability to cover broadly all pledges irrespective of their particular commercial context.

## I

## EXISTING LAW

### *A. Pledge of Securities Deemed a "Sale"*

The Second Circuit was the first to hold that a pledge constituted a "sale" under the federal securities laws. In *SEC v. Guild Films Company*,[11] the court imposed underwriter liability[12] on a bank that knowingly had accepted a prohibited pledge of unregistered stock. Although the *Guild Films* court found sufficient knowledge and intention to sup-

10. *See e.g.*, Hueter, *The Plight of the Pledgee Under Rule 144*, 91 BANKING L.J. 511 (1974); Pierce, *Securities and Exchange Commission v. Guild Films Co.*, 1961 BUS. LAW. 603. The sources of anxiety may include a suspicion that every aspect of the loan agreement may be opened to scrutiny, not only those that concern the pledge. Additionally, rule 10b-5 liability for pledges implies 10b-5 liability for related transactions. The circumstances of a *release* of pledged shares have been subject to liability under rule 10b-5. Mallis v. FDIC, 568 F.2d 824 (2d Cir.), *cert. granted sub nom.* Bankers Trust Co. v. Mallis, 431 U.S. 928 (1977), *cert. dismissed*, 435 U.S. 381 (1978). An important area in which potential securities fraud liability would alter banking practice is the guarantor pledge, since the bank might be held to have omitted material information concerning the borrower's prospects for orderly repayment. *See* note 61 *infra*.

11. 279 F.2d 485 (2d Cir.), *cert. denied sub nom.* Santa Monica Bank v. SEC, 364 U.S. 819 (1960) (construing 15 U.S.C. §§ 77b(11), 77e (underwriter liability)).

12. For the relevant definitions, see Securities Act of 1933, ch. 38, § 2(11), 48 Stat. 74 (codified at 15 U.S.C. § 77b(11) (1976)) (underwriter defined as person purchasing with a view to resale); Securities Act of 1933, ch. 38, § 5, 48 Stat. 74 (codified at 15 U.S.C. § 77e (1976)) (liability for sale or delivery of unregistered securities, but exempting persons other than issuers, underwriters, and dealers). Underwriters are also liable for omissions and misrepresentations in registration statemeuts. Securities Act of 1933, ch. 38, § 11, 48 Stat. 74 (codified at 15 U.S.C. § 77k(5) (1976)).

port this narrow holding,[13] it proceeded to set forth a broader rule characterizing all pledges as a class of transactions covered by the securities laws. In support of this broad dicta the court cited the congressional failure to enact a proposal[14] to exempt from underwriter liability those sales made by good faith pledgees to liquidate a debt.[15] The *Guild Films* case thus commenced a Second Circuit tradition of overbreadth in characterization of pledges.

The Second Circuit reexamined its *Guild Films* analysis sixteen years later in *United States v. Gentile*.[16] *Gentile* held that a pledge of securities to a bank constituted a "sale" under section 17(a) of the 1933 Act.[17] The defendant in Gentile had pledged forged,[18] unauthorized stock certificates. The *Gentile* court reasoned that the pledgee assumes an investment risk insofar as the pledged securities may subsequently decline in value and the pledgee may be unable to force the pledgor to redeem them.[19] The court concluded that there was "no reason to doubt that Congress intended to protect defrauded lenders just as much as defrauded buyers."[20]

Valid commercial justifications support *Gentile*'s reasoning that the particular pledgee had assumed the investment risk in the pledged transaction. If the pledgor defaults on a loan, the pledgee as secured party may sell the security in satisfaction of the pledgor's obligation.[21]

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13. 279 F.2d at 490.

14. S. REP. No. 875, 73d Cong., 1st Sess. § 126 (1933). *See also* Throop & Lane, *Some Problems of Exemption Under the Securities Act of 1933*, 4 L. & CONTEMP. PROB. 89, 124 n.103 (1937).

15. 279 F.2d at 489. The Sixth Circuit was impressed by this reasoning when it followed *Mallis* in Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1028-30 (6th Cir. 1979) (a pledge satisfies "purchase" or "sale" requirement of rule 10b-5). *See also* SEC v. Dolnick, 501 F.2d 1279, 1282 (7th Cir. 1974).

16. 530 F.2d 461 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976).

17. Securities Act of 1933, ch. 38, § 17(a), 48 Stat. 84 (codified at 15 U.S.C. § 77q(a) (1976)) (proscribing fraud in the offer or sale of securities). Although brought under an antifraud provision, *Gentile*, like *Guild Films*, was not a rule 10b-5 case.

18. 530 F.2d at 464. The president of a company in whose care certificates of various companies had been entrusted completed the unauthorized stock certificates in the names of several coconspirators who then sold and pledged the shares. The stock ledgers apparently were also falsified.

19. 530 F.2d at 467. The court in *Gentile* reasoned that title need not pass since the 1933 Act's definition of "sale" ineludes "disposition." *Id.* at 466. The 1934 Act also includes "otherwise dispose of" in the definition of "sale." 15 U.S.C. § 78c(a)(14) (1976). The *Gentile* court could have grounded its holding on the fact that "disposition" of an "interest in a security" is within the 1933 Act. Securities Act of 1933, ch. 38, § 2(3), 48 Stat. 74 (codified at 15 U.S.C. § 77b(3) (1976)). The Second Circuit thus again broadly held that pledges are "sales" of securities where the case presented narrower grounds for decision. Had *Gentile* adopted this narrower holding the case would not have been useful precedent for rule 10b-5 cases since the term "interest in a security" does not appear in the 1934 Act.

20. 530 F.2d at 467.

21. *See* note 6 *supra*.

The pledged securities thus *may* be the only consideration the pledgee will ever receive for the money loaned. Any loss in the value of pledged securities below the value of the loan is a loss in an investment in the securities when the lender is totally dependent on the securities pledged to recoup losses upon loan default. In this situation, the pledgee has assumed the risk of a decline in value of the pledged securities. This assumption of risk is unconditional, even though the loan agreement contemplates repayment, since the securities represent the pledgee's only assurance of loan repayment. This risk is transferred back to the pledgor when the pledgor redeems the pledged securities in return for repaying the loan. Although the securities laws do not seek to protect against *decline in the value* of any securities (whether pledged or sold), "sale" characterization of pledges occurring under these circumstances appropriately extends *fraud* protection to pledges which essentially are securities investments by lenders. *Gentile* thus reaches a sensible result on its facts.

Not all pledges, however, leave the pledgor with the sole remedy of selling the pledged securities in case of default. A pledgee may sue on the note *if* it provides for recourse and *if* the pledgor has sufficient assets to satisfy the award. Where such an alternative remedy is available, the pledgee need not rely on the value of the pledged securities. Since the pledgee does not "invest" in securities in any meaningful sense under these circumstances, rule 10b-5 investor protection is not appropriate. As a result, such a pledge should not be considered a "sale" of securities for rule 10b-5 purposes. Unfortunately, *Gentile*'s broad dicta did not discuss this distinction.

The Second Circuit first applied *Guild Films* and *Gentile* to a rule 10b-5 case in *Mallis v. FDIC*.[22] That case held that a pledge constituted a "contract to sell or otherwise dispose of" a security within section 3(a)(14) of the 1934 Act,[23] thus according Mallis standing to assert a rule 10b-5 claim.[24]

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22. 568 F.2d 824 (2d Cir.), *cert. granted sub nom.* Bankers Trust Co. v. Mallis, 431 U.S. 928 (1977), *cert. dismissed*, 435 U.S. 381 (1978).

23. 15 U.S.C. § 78c(a)(14) (1976).

24. The *Mallis* fact situation involved four parties, two pledges, and an ordinary sale of securities. All of the parties were represented at the closing in which fraud was alleged. The bank released securities pledged it, for satisfaction of a prior loan obligation by a third party pledgor. The third party then sold these same securities to his attorneys. The attorneys pledged these same securities as consideration for a loan from Mallis and another dentist. The money flowed the other way, from Mallis, to the attorneys, to the third party, and to the bank. The fraud alleged was the bank's failure to disclose to Mallis its knowledge that the securities had been cancelled by the issuing corporation pursuant to an earlier agreement. In the end, Mallis was a pledgee with worthless securities, while every other party had obtained some financial benefit from the money loaned on the pledge. The bank was held a "seller" in its release of the third party's pledge, with notice of simultaneous resale. Mallis was held a "buyer" in accepting pledged securities as loan collateral. 568 F.2d at 826-27.

The *Mallis* opinion underscored the *Gentile* rationale that risk of the investment in the worthless shares had passed to the pledgees. Since liquidation of the worthless securities constituted Mallis' exclusive option in his attempt to recover the loaned frauds, he had assumed the risk of a subsequent decline in their market value with the pledge. As in *Gentile*, however, the Second Circuit failed to limit its holding under this rationale to situations where the investment risk *actually* passed to the pledgee.

The unqualified holdings in *Gentile* and *Mallis* suggest that the Second Circuit may hold all pledges to be rule 10b-5 "sales."[25] Under the rationale of those cases, it is possible to infer negatively a "risk test" under which some pledges would not be held "sales."[26] This inference, however, is presently of marginal precedential import at best, since the decisions neither formulate such a "risk test" nor suggest its elements.

### *B. Pledge of Securities Not a "Sale"*

The Fifth Circuit in *McClure v. First National Bank*[27] was the first court of appeals to consider whether a pledge was a "sale" for the purposes of section 10(b) and rule 10b-5. The plaintiff in *McClure* alleged that she had been fraudulently induced to pledge her stock as additional collateral for an overdue commercial loan extended to her husband's business. Essentially, the *McClure* plaintiff claimed that the bank had failed to disclose known material information concerning the weakness of the business' financial status.[28]

The plaintiff contended that *Guild Films* and *Gentile*, though not rule 10b-5 cases, controlled the issue of whether a pledge was a "sale" under the securities laws. The Fifth Circuit held that the *McClure* pledge was not a "sale," distinguishing *Guild Films* on the ground that

25. The Sixth Circuit has subsequently followed the Second Circuit in holding a pledge a "sale" under the rationale that risk passes to the pledgee. Mansbach v. Prescott, Ball & Turbeen, 598 F.2d 1017 (6th Cir. 1979). *Mansbach*'s rationale and language suggest that the Sixth Circuit may hold all pledges to be "sales." *Id.* at 1029. The *Mansbach* court stated that *Blue Chip* did not conflict with "sale" characterization of pledges, because *Blue Chip* was directed at suits by undocumented potential purchasers of hypothetical numbers of shares. The court ruled that a pledge, in contrast, is a discrete and documented event, involving a limited class of "purchasers" and a specific number of shares.

26. *See* text accompanying notes 61-79 *infra*.

27. 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975).

28. Mrs. McClure alleged that her ex-husband and the bank's vice-president obtained her consent on a loan to the corporation of which she owned 50%, on representations of corporate need. This loan was secured by corporately held land, the chief asset of the corporation. The ex-husband then used the loan proceeds to pay his personal debts, giving his own worthless note to the corporation. The bank subsequently extended the one-year note, but required that Mrs. McClure pledge her shares in the corporation. Eventually, the bank foreclosed on the corporation's land, rendering the pledged shares worthless. Since the loan is not a security, 497 F.2d at 495, the only basis for a rule 10b-5 cause of action against the bank here was the bank's fraudulent misrepresentations of the corporation's ability to repay the note for which the pledged shares were additional security.

there had been foreclosure on the security interest in those cases, while no foreclosure had occurred in *McClure*.[29] The court reasoned that the pledge alone, absent foreclosure and liquidation, was without effect on the securities industry.[30]

This reasoning is flawed on two counts. First, the ultimate issue in characterizing the pledge is whether a pledgee is an investor in the pledged securities. Describing a pledge as a "sale" merely suggests that the pledgee has invested in securities. It may be useful to state the issue in terms of the effect on the securities industry if this clarifies the conditions under which pledgees assume the characteristics of investors,[31] but to conclude summarily that pledges should not be "sales" on this basis simply begs the question. Second, by assuming that the scope of rule 10b-5 is limited to preservation of the integrity of the securities markets, it adopts a narrow view of the rule that conflicts with Supreme Court and Fifth Circuit precedents which hold that the protection of individual investors is similarly an intended objective.[32] Subsequent Fifth Circuit pledge cases have taken this broader view.[33]

The Fifth Circuit subsequently applied *McClure* in holding that a pledge absent foreclosure is not a "sale," while reaffirming in dicta that a pledge would be a "sale"[34] if it were a pretext for a sale.[35] It also abandoned prior attempts[36] to harmonize this approach with the precedent from the Second Circuit in *National Bank of Commerce v. All American Assurance Co.*[37] In that case a bank alleged fraud in the pledge of securities as collateral for a loan it extended to an individ-

29. *Id.* at 495-96.

30. The *McClure* opinion identifies the fundamental purpose of the Act as investor protection, but then immediately discusses the effect of pledges on the securities industry. *Id.* at 496. The obvious inference from such a treatment is that the Fifth Circuit assumes that protection of the integrity of the securities markets is the Act's sole means of protecting investors.

31. *See* Part II *infra*.

32. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 10, 12 (1971) (securities transactions not conducted through national or regional security exchanges or an organized over-the-counter market are within the securities laws); Hooper v. Mountain States Sec. Corp., 282 F.2d 195, 201 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961) (10b-5 liability imposed for a face-to-face transaction).

33. *See, e.g.*, National Bank of Commerce v. All Am. Assurance Co., 583 F.2d 1295, 1300 (5th Cir. 1978).

34. *See* Reid v. Hughes, 578 F.2d 634 (5th Cir. 1978) (pledge by a corporation for the benefit of another without sufficient consideration *not* a "sale").

35. National Bank of Commerce v. All Am. Assurance Co., 583 F.2d 1295 (5th Cir. 1978).

36. *E.g.*, McClure v. First Nat'l Bank, 583 F.2d at 1299 (distinguishing SEC v. Guild Films Co., 279 F.2d 485 (2d Cir.), *cert. denied sub nom.* Santa Monica Bank v. SEC, 364 U.S. 819 (1960)).

37. 583 F.2d 1295, 1299 (5th Cir. 1978). Judge Roney also correctly held that *McClure* was indistinguishable on the ground that the plaintiff in *National Bank of Commerce* was a bank, rather than a borrower, citing Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126, 1137 (2d Cir. 1976) (Friendly, J.) (no justification for holding "the same note . . . a security when [a] borrower . . . invoked federal law and not a security when the bank asserted this"). *Cf.* Great W.

ual.[38] The Fifth Circuit gave three reasons for concluding that the pledge was not a "sale."

First, the court reasoned that Congress could have expressly provided for inclusion of the pledge within "sale" had it so intended.[39] The court stated that the Second Circuit's risk-taking rationale "might be a persuasive argument that the federal securities laws ought to encompass pledges," but argued that this was a legislative rather than a judicial consideration. Since rule 10b-5 civil liability is entirely a judicial construction,[40] however, consistent limitation of rule 10b-5 to instances of *express* congressional authorization would bar *all* private 10b-5 suits. The Fifth Circuit, it should be noted, has permitted private 10b-5 suits.[41]

Second, the *National Bank* court conclusorily stated that the purpose of the securities acts to protect investors is not affected by a pledge of securities, and thus that "sale" characterization would not promote rule 10b-5's purpose.[42] As with the similar logic in *McClure*, however, this reasoning does not address the relevant issue.[43]

Third, the *National Bank* court noted that a pledge affords the parties common law rights[44] and statutory remedies[45] different from those

Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976) (Wright, J., concurring).

38. 583 F.2d at 1296-97. Although associations of lending institutions generally have opposed "sale characterization for pledges," *see, e.g.*, Heuter, *supra* note 10, *National Bank of Commerce* demonstrates that lenders as pledgees sometimes will benefit from such characterization.

39. 583 F.2d at 1300.

40. *See* Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). Justice Rehnquist's remarks also are illuminating in this regard:

> When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn. . . . It is therefore proper that we consider . . . what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither congressional enactment nor the administrative regulations offer conclusive guidance. . . . We are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question.

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737-49 (1975).

41. *E.g.*, Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

42. 583 F.2d at 1300.

43. *See* text accompanying notes 31-32 *supra*.

44. 583 F.2d at 1300. Usually a pledgor may sell the stock subject to the security interest, vote the stock, receive dividends, and remain liable for any ad valorem tax. *See generally* L. JONES, COLLATERAL SECURITIES AND PLEDGES §§ 1, 176a, 441, 602 (3d ed. 1912), *cited in National Bank*, 583 F.2d at 1300. *See also* note 6 *supra*. It is true that pledges differ from sales in each of these regards. But by focusing on these differences, which follow from the fact that title does not pass with possession of the pledge, the *National Bank* court implied that rule 10b-5 liability should be determined by the traditional commercial law doctrine of passage of title. This approach conflicts with the deemphasis of the doctrine of passage of title in modern commerical law. For example, the U.C.C. states that "rights, obligations, and remedies . . . do not depend on the location of title" in the article that governs secured transactions like pledges. U.C.C. § 9-101, Official Comment.

45. Whereas sellers have no right to subsequent appreciation in value of the sold securities,

arising in an ordinary sale. Although its rationale is unclear, the court evidently thought rule 10b-5 protection unnecessary and inappropriate where a remedy was available on the note.[46] Rule 10b-5 might afford a remedy, however, in situations in which no other is available.[47] Moreover, plaintiffs in rule 10b-5 actions will frequently have some alternative state remedy since liability under that rule is based on fraud, a traditional common law action. Federal courts,[48] including the Fifth Circuit,[49] have held that availability of common law remedies does not bar rule 10b-5 relief. The *National Bank* court's general thesis that the availability of an alternative remedy undermines the applicability of rule 10b-5 is in conflict with these decisions.

The *National Bank* court may have misinterpreted the significance of the alternative remedy factor.[50] Recent Supreme Court decisions have indicated that this factor should be subordinate to the "central inquiry" of divining congressional intent by the traditional tests of the language and focus of the statute, its legislative history, and its purpose.[51] While statutory purpose alone is helpful in delimiting the scope of rule 10b-5,[52] consideration of the purpose of investor protection casts

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pledgees have a statutory remedy for failure to account for surplus on foreclosure sale of pledged securities. U.C.C. § 9-502(2). For a discussion of other statutory remedies afforded pledge parties under the Uniform Commercial Code, see note 6 *supra.*

46. 583 F.2d at 1300. The court quoted Professor Loss' statement that "federal legislation was hardly needed for privately negotiated pledge transactions between borrowers and lenders." 1 L. LOSS, SECURITIES REGULATION 649 (2d ed. 1961).

47. As the Fifth Circuit stated in an earlier case, "[the implied remedy under rule 10b-5] greatly expands the protection frequently so hemmed in by the traditional concepts of common law misrepresentation and deceit, the requirement of privity, proof of specific damage, inadequacy of the right of rescission or right to recover up to par value of stock of a much greater market value. To these difficulties would have to be added the geographic obstacle of suit in a common forum against multi-state defendants scattered as far as the fraudulent device required." Hooper v. Mountain States Sec. Corp., 282 F.2d 195, 201 (5th Cir. 1960), *cert. denied,* 365 U.S. 814 (1961).

48. *E.g.*, Goldberg v. Meridor, 567 F.2d 209, 220-21 (2d Cir. 1977) (citing Santa Fe Indus., Inc. v. Greeu, 430 U.S. 462 (1977)).

49. Hooper v. Mountain States Sec. Corp., 282 F.2d at 201 (recognizing that rule 10b-5 expands existing common law remedies).

50. *Cf.* Cort v. Ash, 422 U.S. 66, 78 (1975) (whether a cause of action is "traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law" is a relevant factor in determining whether to imply a congressional intent to authorize a private cause of action).

51. Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis, 100 S. Ct. 242, 249 (1979); Touche Ross & Co. v. Redington, 99 S. Ct. 2479, 2489 (1979).

52. Reference to the language of the 1934 Act or of rule 10b-5 is of little assistance in deciding whether pledges should be treated as "sales." *See* notes 1 & 2 *supra.* The 1934 Act's legislative history also offers little guidance on the question, since it apparently does not refer to pledges one way or the other in the "sale" context. Although inferences drawn solely from legislative purposes may not be entirely persuasive, *cf.* Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis, 100 S. Ct. at 249 ("But the mere fact that the statute was designed to protect advisers'

doubt on Fifth Circuit reliance on availability of alternative state remedy. An alternative state action may be available on the note, yet may be ineffective due to insufficiency of the pledgor's assets. Thus, the pledgee will have assumed investment risks of decline in value of the pledged securities since sale of the security at market price is the only viable remedy to pledgor default. By neglecting the possibility of *ineffective* state remedies, the Fifth Circuit's "alternative state remedy" test inadequately advances rule 10b-5's objective of investor protection.

### C. *Thwarted Resolution*

The Second and Fifth Circuits appear to be irreconcilably split on the issue of whether a "pledge" constitutes a sale under the federal securities laws. After *Mallis* it appears that the Second Circuit will hold all pledges to be rule 10b-5 "sales."[53] In contrast, after *National Bank* it seems that the Fifth Circuit will hold no pledges to be "sales," subject to discrete exceptions.[54] Although overly broad dicta has made this

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clients does not require the implication of a private cause of action for damages on their behalf"), they are the only available guides in this case that comport with the Supreme Court's recent pronouncements. *See* note 51 *supra.*

The legislative history of the 1933 Act indicates that the purpose of the law was "to protect the investing public and honest businesses." Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1041 (7th Cir. 1979) (quoting legislative history of 1933 Act). Since indications of meaning about the 1933 Act are relevant in construing the 1934 Act, *see* Tcherepnin v. Knight, 389 U.S. 332, 335-36, 342 (1967), these statements are relevant to the coustruction of § 10(b) of the 1934 Act and its accompanying rule 10b-5. Professor Loss has ascribed four basic purposes to the 1934 Act, which extended the disclosure policy of the 1933 Act to the secondary market. These additional purposes are (1) to afford disclosure to purchasers and sellers, (2) to prevent and afford remedies for securities fraud and manipulation, (3) to regulate the securities markets, and (4) to control the proportion of the national credit in those markets. 1 L. Loss, *supra* note 46, at 130-31.

53. The Sixth Circuit subsequently followed the Second Circuit's "better reasoned" authority. Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1029 (6th Cir. 1979). The Seventh Circuit instead applied the Fifth Circuit's approach in holding that a pledge is not a "sale" absent foreclosure. Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1044 (7th Cir. 1979). In support of its holding, the *Herber* court reasoned that the purpose or motive of a transaction has been given controlling significance in the two recent Supreme Court opinions of United Housing Inc. v. Forman, 421 U.S. 837 (1975) (shares in housing cooperative not a "security") and International Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979) (employee's participation in noncontributory, compulsory pension plan not a "security" or "investment contract"). 604 F.2d at 1042-43. Both *Forman* and *Daniel* rejected literal application of the securities law in favor of an analysis looking to the "underlying economic realities," as the *Herber* court itself recognized. *Id.* at 1043. *Herber* dismissed the economic reality of the risk transfer that accompanies some pledges by stating that it did "not dispute the existence of a risk; however, the risk is taken for the purpose of making a loan, not for the purpose of investing in the securities." *Id.* at 1042. By thus failing to address the question of whether a pledge is an investment, *Herber* ignored the commercial fact that the pledgee in some circumstances may rely solely on the market fluctations of the pledged securities' value for avoidance and relief in the event of pledge default. *See* text accompanying note 21 *supra.* This Comment argues this assumption of the risk of market valuation of assets is the central "underlying economic reality" in pledge transactions in the federal securities laws context.

54. The two exceptions appear to be situations where there has been an actual foreclosure of

conflict more apparent than real, neither circuit has identified the distinctions necessary to facilitate a more discriminating approach to this problem.

The Supreme Court took the opportunity to clarify this dispute by granting certiorari in *Mallis*.[55] Although the characterization of the pledge in *Mallis* was briefed by the parties and amici on both sides,[56] the suit was dismissed as improvidently granted.[57] The Court's reason for dismissing the suit was that counsel for respondent Mallis stated in oral argument that the "mere release of a pledge is [not] a sale."[58] This concession by Mallis was inconsistent with Mallis' position that the defendant bank was liable to him under rule 10b-5.[59]

The reason for this concession in oral argument is not apparent. In response, the Court could have reversed the Second Circuit in an opinion strengthened by the concession. Instead, the Court took the highly unusual step of dismissing certiorari and leaving the Second Circuit decision—favoring Mallis, the conceding party—in force. Whatever the rationale for the Court's disposition might have been, it is apparent that the dismissal of certiorari does not reflect a judgment of the merits of the lower court's decision.[60] An authoritative resolution of the matter will therefore require further litigation before the high court. In the interim, however, it is possible to fashion a sensible compromise test from relevant aspects of the various decisions in this area.

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a security interest or where the pledge is a pretext for an ordinary sale and consequent passage of title. 583 F.2d at 1299. In a case where foreclosure had taken place, the Ninth Circuit cited *McClure* in holding that disposition of the plaintiff's pledged shares in a foreclosure sale satisifed the purchaser-seller requirement. Bosse v. Crowell, Collier and Macmillan, 565 F.2d 602, 611 (9th Cir. 1977).

55. Bankers Trust Co. v. Mallis, 431 U.S. 928 (1977). The Court took the case despite some preliminary procedural difficulties it presented, *see* Bankers Trust Co. v. Mallis, 435 U.S. 381, 382-88 (1978) (per curiam), thus indicating substantial interest in the issue.

56. Amici briefs were submitted by the Securities Exchange Commissiou, supporting the characterization of a pledge as a "sale," and the New York Clearing House Association, opposing such a characterization. 435 U.S. 381.

57. *Id.*

58. *Id.* at 388.

59. Mallis v. FDIC, 568 F.2d at 826-27. The bank defendant in *Mallis* was not a party to the pledge, although it had released the simultaneously pledged shares from another pledge in a related transaction. *See* note 24 *supra*. The pledge release thus had to be a "sale" if the bank was to be subjected to rule 10b-5 liability.

60. *See* Ferguson v. Moore-McCormack Lines, Inc., 352 U.S. 521, 526 & n.4 (1957) (Frankfurter, J., dissenting).

## II

## A Compromise Test: "Investment" in Pledged Securities

The statutory language of section 10(b) and rule 10b-5 offers little guidance about whether or when pledges should be considered 10b-5 "sales."[61] An alternative criterion for construing the Act's terminology is whether the particular "alleged conduct is of the type of fraudulent behavior which was meant to be forbidden by the statute and the rule."[62] Since a central purpose of section 10(b) and rule 10b-5 is to protect securities investors from fraud,[63] the key to appropriate treatment of pledges under the securities laws should be a determination of the conditions under which the person receiving securities as a pledge can be said to "invest" in them. Risk-taking in securities markets is the economic essence of securities investment;[64] accordingly, a pledge should be characterized as a rule 10b-5 "sale" whenever the pledgee assumes the investment market risk that the pledged securities will decline in value.

The pledgor in pledge transactions normally retains the nominal characteristics of securities investment, including title, dividend rights, and right to an accounting for surplus upon foreclosure. The pledgor will be effectively insulated from loss in the securities market, however,

61. *See* notes 1-2 *supra*.

62. SEC v. National Sec., Inc., 393 U.S. 453, 467 (1969).

63. Another primary goal of the securities laws is the preservation of the integrity of the securities markets. *See* note 52 *supra*. If the markets are viewed broadly as including transactions in which risks are taken in securities, then any definition which will serve to protect the entire class of investors will also preserve the integrity of the markets.

64. The Second Circuit recognizes that the key feature of "investment" for purposes of a rule 10b-5 "sales" characterization is the assumption of risk that the securities' value may decrease. *See* text accompanying notes 19-26 *supra*. The Fifth Circuit agreed that such an approach was "persuasive," *see* text accompanying notes 39-40 *supra*, but considers such a rationale legislative in character. *But see* notes 39-41 and accompanying text *supra*.

This analysis of whether a transaction shifts this investment risk from one party to another is consistent with cases treating unusual "sales." For example, in Dasho v. Susquehanna Corp., 380 F.2d 262, 266 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967), *cited with approval in* SEC v. National Sec., Inc., 393 U.S. 453, 468 (1969), the court said that the 1934 Act's statutory "sales" language is "not limited to transactions ordinarily governed by the commercial law of sales" and held that a stock for stock transaction in a merger constitutes a "sale" under that statute. Since shareholders accept a package of risks distinctly different from those previously held when one type of security is transformed into another, a focus on whether investment risk shifts would label such a transaction a "sale." This is consistent with the rule of the case.

This approach is also consistent with Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), which held that rule 10b-5's "sale" requirement is not met where the sale is potential rather than actual. Actual sales can most clearly be distinguished from potential sales by the characteristic assumption of market risk in the former. It will serve the *Blue Chip* standard if "sale" is limited to those transactions in which risks of investment in securities have been assumed. Whether such risks were assumed is best determined by examining the availability of recourse and the borrower's ability to repay to determine the underlying economic realities of the transaction.

whenever the terms of the pledge transaction leave the pledgee with no effective remedy apart from selling the securities in the event of pledge default. If the market price of the securities falls below the amount due on the note and the pledgee has no effective remedy other than sale of the securities, the pledgor may have little incentive to repay the lender in order to redeem the securities. The pledgee has only the threat of sale to force repayment. In this situation, the pledgee relies on the securities market determination of value and thus invests in the seeurities for the term of the pledge.

Rule 10b-5's antifraud protection for investors should extend to include those pledgees who have assumed the market risks of investment in the pledged securities. In situations in which other effective remedies remove the pledgee's sole reliance on sale of the securities to guard against default, however, the pledgee does not bear the investment market risk that the value of the securities might decline. In this case, rule 10b-5 investor protection is not appropriate since the transaction is not a securities "investment."

"Sale" characterization of pledges should therefore depend on the existence and efficacy of the lender's remedy on the note in the particular case.[65] A central consideration in current judicial determinations in this context is the statutory availability of recourse, which typically provides the lender with the right to proceed against the borrower and pledgor for any deficiency remaining after foreclosure on the lender's security interest in the pledged securities.[66] A large proportion of notes secured by pledges of securities, however, preclude the right to recourse.[67] Thus, the first step in pledge characterization should consist of a determination of recourse availability under the statute and con-

65. For a discussion of the legal consequences of pledging securities as consideration for a loan, see note 6. The lender's remedy "on the note" is an actiou for performance or damages on the loan contract.

66. U.C.C. § 9-504(2).

67. The availability of recourse thus is generally easily determined as a matter of state law and the contract between the parties. This aspect of the proposed test can be illustrated with the following hypothetical. *A*, Inc. borrows $6 million from Bank on a nonrecourse, fully subordinated loan to meet its current operating expenses in its manufacturing plant. *A*, Inc. puts up its own bonds as collateral. *A*, Inc.'s net assets are zero. *A*, Inc. subsequently defaults, and is declared bankrupt. In an attempt to obtain some advantage over other creditors, Bank alleges fraud in the preparation of the financial statements, asserting that the pledge was a "sale" under rule 10b-5.

Because this is a nonrecourse loan, the bank is solely dependent on the continued value of the *A*, Inc. bonds pledged for repayment in case of default. *A*, Inc.'s ability or inability to repay is irrelevant. Since Bank assumed the risks of investment in the pledged *A*, Inc. bonds, the pledge should be considered a rule 10b-5 "sale."

Although the loan was fully subordinated to all other creditors, Bank may now hope to obtain advantage by elevation to the status of general judgment creditor. This rewriting of loan tcrms would be justifiable only if fraud is proven, since Bank did not bargain for fraud. This possibility should spur *A*, Inc.'s major creditors to closely monitor the financial statements that *A*, tract governing the particular transaction. If recourse is unavailable, then "sale" characterization is appropriate, since the pledgee's total dependence on the pledged securities makes him an investor in those securities.

Recourse may be ineffective even where available under the applicable statute and contract, however, if the pledgor has insufficient assets to satisfy a deficiency. Under the second prong of the proposed test, therefore, a pledge would be characterized as a rule 10b-5 "sale" only if the objective[68] value of the pledgor's assets (net of exempt assets)[69] is less than the value of the pledge obligation at the time that the pledge is transacted.[70] This two-pronged approach, while admittedly more complex than a straightforward determination of recourse availability, serves the purpose of protecting the entire class of pledgees who actually assume risks of investment in pledged securities.

In making the calculation of the borrower's financial standing, a court should exclude the value of any other securities of the issuer of the pledged securities owed by the pledgor. The distinctive feature of effective recourse is that it provides the pledgee with a remedial alter-

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Inc. presents to the public and uses in loan negotiations. It should be noted that other secured creditors could look to their security interest for satisfaction of outstanding obligations to them.

According to this aspect of the proposed test, the lender that accepted pledged shares as collateral for a nonrecourse loan in *National Bank* should have been allowed to state a rule 10b-5 cause of action based on the pledge as a security "sale." *See* text accompanying note 38 *supra*. In contrast, the worthless securities in *Mallis* were apparently pledged for a nonrecourse loan, thus indicating that the Second Circuit was correct in holding that pledge to be a "sale." *See* text accompanying notes 25-26 *supra*. The propriety of holding the *Mallis* pledge *release* to be a sale cannot be determined without knowing the facts of the prior third party pledge. Even if it would have been proper to hold that release a "sale," the release's "connection" with the fraudulent pledge transaction is not established in the opinion. *See* notes 2 & 24 *supra*.

68. A court should assess pledgor's financial standing by actual balance sheet information rather than by representations or subjective belief at the time of pledge. Pledgors may misrepresent the extent of their assets and consequently the effectiveness of recourse, thus wrongfully convincing pledgees that the pledge involves no investment risk in the pledged securities. These misrepresentations and pledgees' resulting subjective beliefs should be irrelevant to "sale" characterization in order to avoid the ironic result of permitting pledgors to escape rule 10b-5 antifraud liability because they were successful in misleading the pledgee at the time of pledge.

69. Every state specifies that certain assets are exempt from creditors, including judgment creditors, under specific circumstances. Among the assets that might be exempt are a homestead, life insurance policies, tools of the trade, personal clothing, the plow, the mule, toys, and necessary medical equipment. Often exempt assets are subject to purchase money liens. *See, e.g.*, CAL. CODE CIV. PROC. §§ 690-690.29 (West Supp. 1979). *See generally* Vukowich, *Debtors' Exemption Rights*, 62 GEO. L.J. 779 (1974). Since these assets are not available to a party suing on a note, their value should be excluded from the calculation of the pledgor's net worth.

70. The borrower's financial standing at the time of default or suit may differ dramatically from his or her financial standing at the time of pledge. It is appropriate to evaluate the pledgor's assets as of the time of the pledge transaction so that the pledgor can contemporaneously determine whether he or she owes a rule 10b-5 duty of material disclosure. Compliance with this duty often is burdensome. It would not be fair later to impose rule 10b-5's strictures when the pledgor could have had no means of ascertaining at the time whether such a duty was owed.

native to reliance upon the value of the pledged securities; if recourse is simply another form of reliance on other securities of the same issuer owned by the pledgor, the pledgee again assumes the risk of investing in that issuer.[71] Additionally, the source of investment risk for the pledgee is the threat that the value of the pledged securities might decline. If this occurs, other securities of the same insurer may well be similarly affected. For these reasons, the value of any of these other securities should not be included in any calculation of the pledgor's assets available to cover the value of the pledge.

In marginal cases it is appropriate to consider the use of the loan proceeds. Where the proceeds are invested to enhance the net worth of the pledgor, the pledgee's dependence on the pledged securities is lessened. But if the proceeds are allocated to current expenses or are spent for the benefit of a third party, the resulting diminution of net worth will increase the pledgee's reliance on the continued value of the pledged securities. The consideration of the actual[72] use of loaned money could be the determinative factor in cases otherwise in equipoise.[73]

Courts are competent to consider recourse and financial standing in determining whether investment risk passes in pledge transactions.[74]

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71. This risk would be assumed unless the pledgor has *other* assets sufficient to cover the obligation. But even where there are other assets to which the pledgee has recourse, the pledgee still assumes the risk that these other assets will decline in value during the term of the pledge. This type of *lender's risk*, however, should not be characterized as an investment market risk for purposes of the "sale" inquiry, since this lender's risk accompanies *any* loan. Unless one seeks to extend the securities laws to lending situations of every type and thus define all leuders as "investors," the relevant risk for characterizing pledges as rule 10b-5 "sales" should be confined to the pledgee's risk that the *pledged securities* will decline in value. *Cf.* Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1043 (7th Cir. 1979) ("Risk there is, but the risk is not an *investment* risk.") (emphasis in original).

72. The relevant consideration should be what was *actually* done with the pledge funds, not what the pledgor represented would occur. *See* note 68 *supra*.

73. When deciding whether a note instrument is a "security" for purposes of applying the federal securities laws, some courts seem to consider the time duration of the note to be a significant factor. *See, e.g.*, Amfac Mfg. Corp., 583 F.2d 426, 432 (9th Cir. 1978); United Cal. Bank v. THC Financial Corp., 557 F.2d 135 (9th Cir. 1977). This is not to be a relevant consideration when determining whether a pledge constituted a "sale." Both the pledgor's ability to repay the pledge—measured by his or her assets—and the value of the pledged securities may fluctuate over time. There is no a priori reason to believe that increased passage of time will affect these two variables in any predictable fashion. Asset value could decrease in proportion to the value of the securities (thus making the pledge look more like a "sale"), asset value could increase in proportion to the value of the securities (thus making the "sale" characterization less apt), or both could offset each other by simultaneous increase or decrease. Duration of the pledge consequently does not appear to be a useful guide for the "sale" characterization of the pledge.

74. Application of the proposed test is illustrated in the following three hypotheticals.

*Hypothetical 1: C* pledges his stock in *D*, Inc. to Bank as guarantor on a $100,000 loan to his nephew *F*, so that *F* can opeu a law office. The documents provide for full recourse against both borrower and guarantor. *C*'s net worth excluding his position in *D*; Inc. is $100,000. Eighty thousand dollars of this represents his equity in his homestead, exempt from creditors under state

In some regards this test is similar to that employed by the courts to determine whether a given note is a "security" and thus subject to federal securities regulation.[75] In both cases the issue is whether an invest-

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law. *F* has a net worth of negative $20,000. *F* defaults and *C* receives notice to redeem the securities. *C* sues Bank for fraud under rule 10b-5, alleging that Bank failed to disclose that *F* had defaulted on several auto loans in the past and that the bank knew the statistical probability of new graduates surviving in solo practice is extremely low.

Since recourse is available here, the inquiry proceeds to the second factor: the ability of the borrower to repay the loan. This borrower has no net assets. The inquiry would conclude here, with a holding that the pledge was a "sale," if this were not a guarantor situation. The assets of the guarantor must be considered, however, because the documents allow recourse against the guarantor as well. The net value of *C*'s nonexempt assets is far less than the amount borrowed, so it may be inferred that the bank was relying on the continued value of the pledged securities for repayment in event of default. Since the existing remedy on the note would be ineffective, the investment risks in the pledged securities passed to the lender in the pledge transaction. The pledge consequently should be treated as a "sale," and the rule 10b-5 action allowed. Similarly, in *McClure*, recourse which was ineffective against the corporate borrower may have been equally ineffective against the guarantor. *See* text accompanying notes 27-32 *supra*. Where recourse is inefficacious, any party to a pledge transaction should be allowed to allege it as a "sale" to state a rule 10b-5 cause of action since the protected class of investors includes both purchasers and sellers. *See* notes 1 & 2 *supra*.

*Hypothetical 2: G* and *H* get a $200,000 full recourse loan from Bank, putting up equal amounts of *L*, Inc. stock as collateral. The note proceeds are to be devoted to purchase of new production machinery. *G*'s net worth, excluding a substantial position in *L*, Inc. is $8,000, all in exempt tools of his trade. *H*'s net worth, excluding his position in *L*, Inc., is $210,000, all nonexempt. The market for *L*, Inc. stock disintegrates with news that the corporation is in default and that *G* absconded with the loan proceeds to a foreign country. Bank sues *H*, who countersues for fraud under rule 10b-5, alleging that the bank failed to disclose that *G* had defaulted on similar arrangements in the past.

Full recourse exists and *H*'s net worth exceeds the amount borrowed. Since the remedy on the note at state law both exists and is efficacious, the risks of investment in *L*, Inc. did not pass in the pledge. There thus should be neither a "sale" found nor a rule 10b-5 action permitted. The two debtor situation is analogous to the guarantor situation, wherein the lender may reasonably rely on nonexempt assets of either borrower or guarantor. Similarly, if the guarantor in *McClure* possessed sufficient nonexempt assets, no rule 10b-5 "sale" should have been found. *See* text accompanying notes 30-32 *supra*.

*Hypothetical 3: X*, the retired president and founder of *Y*, Inc., offers 600 shares of *Y*, Inc. as collateral for a loan from Bank to pay necessary medical expenses. The market valuation of the *Y*, Inc. shares offered is $6,000, but these shares are not widely traded. Knowing that *X* is completely insolvent, but that a revolutionary switching device was recently developed at *Y*, Inc. laboratories, Bank goes through with the loan. Neither *X* nor the general public are aware of the breakthrough. *X* breaches the loan obligation, Bank sells the *Y*, Inc. shares now worth $60,000, and accounts to *X* for the excess only after tacking on very substantial transaction costs. *X* learns that Bank was guided by undisclosed inside knowledge in taking the pledge. He files a rule 10b-5 action based on the pledge.

Since *X* was completely insolvent, Bank assumed the risks of investment in the pledged securities. The characterization of the transaction as a rule 10b-5 "sale" thus serves two laudable purposes. First, it protects the frequently insolvent entrepreneur from overreaching by less scrupulous lending institutions. Second, it insulates risk-taking pledge transactions involving infrequently traded issues from the taint of inadequate disclosures by either party.

75. The courts have much experience with this issue. *E.g.*, Great W. Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976); C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973). The characterization of a note as a "security" has also

ment situation exists that merits the application of federal securities law.[76] The Supreme Court has admonished courts to focus on economic reality when defining the term "security,"[77] and the Ninth Circuit has applied a multifactor "risk capital" analysis as a means of making this characterization.[78] The experience gained with this type of inquiry indicates that the proposed pledge "sale" test is within the judicial ken.

The two-pronged analysis of availability and efficacy of recourse should not present undue conceptual or practical difficulties in future judicial determinations. The proposed test does lack the extreme simplicity and predictability of either the Second Circuit approach—apparently holding all pledges to be "sales"—or the Fifth Circuit approach—apparently holding virtually no pledges to be "sales"[79]—but nevertheless would constitute a manageable approach to a complex problem. Furthermore, it is the only rule that is consistent with the logic of the federal securities laws in extending rule 10b-5's investor protection exclusively to those who effectively invest in the securities market.

## CONCLUSION

Although the pledge of securities in consideration for a loan is a commercial transaction of substantial commercial significance, its mixed characteristics seem to make it difficult to classify under the federal securities laws. The circuits consequently disagree about whether

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been the subject of much commentary. *See, e.g.*, Katz & Lipton, *"Notes" Are Not Always Securities*, 30 BUS. LAW. 763 (1975); Katz & Lipton, *"Notes" Are (Are Not?) Always Securities: A Review*, 29 BUS. LAW. 861 (1974); Comment, *Commercial Notes and Definition of "Security" Under Securities Exchange Act of 1934: A Note is a Note is a Note?*, 52 NEB. L. REV. 478 (1973); Comment, *Securities Regulation-Commercial Paper-Promissory Notes with Maturity Not Exceeding Nine Months But Offered to Public as Investment Are "Securities" Within Section 3(a)(10) of the 1934 Act*, 26 VAND. L. REV. 874 (1973); Note, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362 (1972).

76. Characterizing a pledge of securities as a "sale" determines that the transaction is an act of investment in the pledged securities. Characterizing a note instrument as a "security" determines that the instrument documents an investment in the borrower's enterprise. Both tests should focus on whether the individual has assumed investment risks in return for the money tendered.

77. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

78. Amfac Mfg. Corp. v. Arizona Mall of Tempe, 583 F.2d 426, 431-32 (9th Cir. 1978); United Cal. Bank v. THC Financial Corp., 557 F.2d 1351, 1358 (9th Cir. 1977); Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1256-57 (9th Cir. 1976). Under "risk capital" analysis the ultimate question is whether the lender's money is "subject to the entrepreneurial or managerial efforts" of others. *Id.* at 1257. In "risk capital analysis," the Ninth Circuit applies six nonexclusive factors, none of which alone is dispositive: (1) time, (2) collateralization, (3) form of the obligation, (4) circumstances of issuance, (5) relationship between the amount borrowed and size of borrower's business, and (6) the contemplated use of the funds. 557 F.2d at 1358.

79. *See* text accompanying note 54 *supra*.

pledges amount to "purchases" and "sales" of securities. Hence, the question of whether rule 10b-5 liability should be extended to such transactions is not accorded uniform treatment in the federal courts.

This conflict should be resolved by adopting a two-pronged test that incorporates the divergent analyses currently in effect. The central inquiry in this context should be whether securities market investment risk shifts between the parties as a result of the pledge transaction. A secondary determination of whether the agreement and its accompanying circumstances provide for effective recourse against the pledgor will indicate whether the pledgee was solely reliant upon the market value of the pledged securities in the event of pledge default. The pledgee who was entirely reliant upon the market value has effectively become an investor in securities, and rule 10b-5 protection is appropriate. Transactions failing to satisfy this test do not involve securities investment, and therefore do not warrant the application of rule 10b-5 liability.

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