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Michigan Court of Appeals Broadens Potential Exposure to Securities Fraud by Issuers and Sellers of Debt Instruments in Michigan

May 31, 2023

If your Michigan business issues promissory notes or other evidence of indebtedness, or if you purchase such debt instruments, it is important to understand whether those debt instruments could be considered "securities" under the Michigan Uniform Securities Act ("MUSA"). If a debt instrument is deemed a security, the issuer could not only be liable to the purchaser for any damages caused by any misstatements or omissions made in connection with issuance, but also be sanctioned by Michigan's securities regulator or criminally prosecuted for securities fraud, selling securities without a license, and selling unregistered securities. A recently published Court of Appeals decision broadens the MUSA definition of a "security," significantly expanding potential liability under the statute.

In *LA Developers, LLC and David Byker v. Department of Licensing and Regulatory Affairs* (2023), the Michigan Court of Appeals changed the law in Michigan, holding that Michigan courts must now use the "family resemblance test" from the 1990 U.S. Supreme Court decision in *Reves v. Ernst & Young* to determine whether a note is a security under the MUSA.

Pertinent Facts Related to the Note in *Byker*

In *Byker*, a real estate developer offered to buy plaintiff's $200,000 investment interest in a Costa Rican condominium development for $280,000. The developer gave plaintiff a note requiring the developer to make a down payment of 5% of the note amount ($14,000) to plaintiff, and 5% interest-only payments each year, with the remaining principal due in 5 years. The developer paid the down payment and annual interest payments for a total of $67,200, but refused to make the final balloon payment in year 5. Plaintiff sued the developer and settled the dispute for $225,000. Plaintiff then filed a complaint with the Corporations, Securities, and Commercial Licensing Bureau of the Michigan Department of Licensing and Regulatory Affairs ("the Bureau"). The Bureau fined the developer $30,0000, finding that the developer violated MUSA by making material misstatements and omissions when it offered to sell the plaintiff a note in exchange for her equity interest in the condo project.

The developer asked for a hearing. Citing the 1978 Michigan Court of Appeals decision in *People v. Breckenridge*, the Administrative Law Judge held that the Bureau lacked jurisdiction to fine the developer because the note was not a "security" under MUSA. The Bureau asked the Administrator to affirm the sanctions order by finding that the note was a security under the federal *Reves* test. The Administrator agreed with the Bureau, and remanded the case to the ALJ to apply *Reves*, which the ALJ did and determined the notes were securities under *Reves*. The developer appealed to the Michigan circuit court, which held that the *Reves* test could not be applied because it conflicted with Michigan law on three points: 1) unlike the federal securities act interpreted by *Reves*, Michigan law did not presume that notes are securities; 2) Michigan law did not treat the fixed rate of interest under the note as profit; 3) Michigan law required public solicitation of venture capital to be used in a business enterprise. Therefore, the trial court ignored *Reves* and followed *Breckenridge* and the 1988 Michigan Court of Appeals case styled *Ansorge v. Kellogg* to find that the note was not a security.

Byker **Found that the** ***Reves*** **Test Was Not Inconsistent with Michigan Law**

Byker distinguished the three ways the trial court said *Reves* conflicted with Michigan law:

1. MUSA creates the same presumption that a note is a security that *Reves* found in the federal securities laws

The trial court said that "nothing in [MUSA] suggests that the Legislature intended to create a presumption that promissory notes are securities." *Byker* said the lower court overlooked the fact that *Reves* found the presumption because the federal act defined a "security" as "any note." MUSA defines a security as "a note." After finding no meaningful distinction between the use of "any" and "a" before note, *Byker* found no reason the same presumption *Reves* found in the federal act did not apply under MUSA. *Byker* noted that both the federal act and MUSA definition begin by stating that the definitions apply "unless the context otherwise requires." Thus, a plain reading of MUSA and the federal act provide that a note is a security "unless the context otherwise requires," which in the case of a note is whether the *Reves* test rebuts that presumption.

2. A fixed-rate of interest in a note does not compel a finding that it's not a security

The trial court relied on the 1988 *Ansorge* decision from the Michigan Court of Appeals, which found that notes were loans and not securities because they were exchanged for cash and had a fixed interest rate. First, *Byker* cited the court rule that *Ansorge* isn't binding because it was decided before 1990, which is ironically the same year *Reves* was decided. Second, *Byker* found that *Ansorge* was limited to its facts related to notes issued by a fruit processing company to cherry growers, with the court observing that the fixed rate of return did not depend on the note issuer's profits in that case. But *Byker* did not read *Ansorge* to mean that fixed interest can never be "profit," and thus not an investment security. *Byker* found this was so even though the notes in *Reves* had interest rates that were "constantly revised" to keep them above local bank rates. *Byker* did not read *Reves* to mean a fixed rate can never constitute a "profit." *Byker* said that the lower court would need to review the entire transaction and determine "whether the transaction looks like a business investment or a purely commercial or consumer transaction." And while the income or return on investment a note provides is relevant to applying the *Reves* test, *Byker* found that "it does not affect whether the *Reves* test is consistent with Michigan law."

3. The trial court did not support its claim that Michigan securities involve solicitation of venture capital

Quoting *Ansorge*, the trial court found *Reves* inconsistent with a quote in *Ansorge* that "the 'salient feature of a security sale in Michigan' is the public solicitation of venture capital.'" *Byker* quickly dispatched with this argument since the trial court did not explain "how this is inconsistent with the *Reves* test."

Byker **Found that it Should Adopt the** ***Reves*** **Test as Michigan Law**

Byker said that since MUSA employs language similar to the federal act, adopting the *Reves* test furthers the Michigan Legislature's goal, recognized in *Breckenridge*, of promoting uniformity in federal and state securities standards. *Byker* noted earlier in its opinion that Section 608(2) of MUSA requires an interpretation "[m]aximizing uniformity in federal and state regulatory standards." And because MUSA and the federal act define securities as notes, and both state that this definition applies "unless the context otherwise requires," the presumption recognized by *Reves* and the family resemblance test to rebut that presumption "is consistent with Michigan law and better serves the plain language of the

Legislature's definition." *Byker* also observed that the *Reves* presumption aligned with Section 503(1) of MUSA, which places the burden on a person claiming an "exemption, exception, preemption, or exclusion" to prove it.

Byker Found That MUSA's 5-Factor Test to Determine Whether "Contracts" Are Securities Did Not Apply to Promissory Notes

The initial definition of "security" in MUSA and the federal act are substantially similar, including that both list a "note" as a security. But unlike the federal act interpreted by *Reves*, MUSA's definition ends with a list of six specific additional categories of instruments that are or are not included in the term "security" under Michigan law. *See* MUSA, Section 102(c)(i)-(vi). The first category creates a 5-part test to determine whether a "contract or quasi-contractual arrangement" is a security. *See id*, Section 102(c)(i)(A)-(E). *Byker* noted that the Michigan case of *Ansorge*, which the trial court relied on instead of *Reves*, used this 5-factor test to determine whether the note in that case was a security. *Byker* held that this was an error because a plain reading of MUSA reveals that the 5-factor test only applied to instruments that are a "contract or quasi contractual arrangement," and not note instruments. "If the five-factor test were intended to be applied to all instruments to determine if they are a 'security,' there would be no need for the Legislature to provide such an extensive list of items that are securities. Rather, it would merely have set forth the five factor test." In support of this holding, *Byker* cited the 1990 Michigan Court of Appeals decision of *Noyd v. Claxton, Morgan, Flockhart & VanLiere*, which applied the 5-part test to a "loan participation agreement" because it was a contract that was not a listed instrument in the main definition of security.

Though Not Addressed by _Byker_, MUSA's 5-Factor Test Appears to Codify the 1946 U.S. Supreme Court Decision of _SEC v. WJ Howey_, Which is the Test to Determine Whether "Investment Contracts" are Securities and Does Not Apply to Notes

The U.S. Supreme Court's 1946 decision in *SEC v Howey* involved a Florida citrus company that raised money by selling portions of its grove through a land sales contract and warranty deed, and then used a service contract to take a leasehold interest in the land with the sole right to harvest and market the citrus. The landowners/lessors were paid a percentage of the profits of the business by the company lessee based on their ownership interest. Because these investment contracts were not defined as a security under the 1933 Securities Act, the *Howey* Court constructed an "economic reality" test to determine whether these undefined "investment contracts" are securities. Each element of the *Howey* test for "investment contracts" is found in the 5-part test for a "contract or quasi-contractual arrangement" under MUSA: a person furnishes capital; it is subject to the risk of the issuer's enterprise; a promotor is used to represent a valuable tangible benefit from the operation of the enterprise; the person furnishing the capital is not involved in the management of the enterprise; and the promotor anticipates a financial gain from the provision of capital. One *Howey* factor — "investment in a *common enterprise*" —is found in a separate MUSA definition, though that definition does not reference the critical contract component of the *Howey* test.

This is important because the U.S. Supreme Court would twice hold that the *Howey* test for investment contracts cannot be used to determine whether any other instruments are securities under federal law, which is exactly what *Byker* said about the 5-part MUSA test for contracts. In its 1985 decision in *Landreth Timber Co v. Landreth*, the U.S. Supreme Court held that the *Howey* test had to be limited to investment contacts because applying it to "traditional stock and all other types of instruments listed in the statutory definition would make the Act's enumeration of many types of instruments superfluous." *Reves* applied *Landreth* in 1990 to say the same thing about promissory notes. In other words,

the rationale employed by *Byker* to limit MUSA's 5-part test to contracts is supported by the U.S. Supreme Court's rationale in *Reves* and *Landreth* that the *Howey* test is limited to investment contracts.

Though Not Addressed by *Byker*, *Reves* Did Not Address the "Evidence of Indebtedness" Instrument Included as a Security in MUSA But Not in the Federal Act Examined by *Reves*, Which Presents Another Argument in *Byker* On Remand

The federal 1934 Securities Exchange Act definition of security, interpreted by *Reves*, does not include "evidence of indebtedness." So the *Reves* test on its face does not apply to that instrument. MUSA's definition of security does include "evidence of indebtedness," as does the federal 1933 Securities Act. As a general matter, the 1934 Exchange Act applies to purchases and sales of securities, while the 1933 Securities Act only applies to sales of securities by issuers. This presents an opportunity for a plaintiff to plead that the debt instrument at issue is "evidence of indebtedness," and thus a security under MUSA, even if that instrument fails to qualify as a note security under the *Reves* test. In *A.E. Smith v. C.E. Manausa,* a federal trial court in Kentucky found that an agreement to buy shares with a "corporate note" payable in nine months "clearly reveals a 'note' or 'evidence of indebtedness' under the 1933 Act." The note in *Manausa* is similar to the note in *Byker* that was delivered in exchange for plaintiff's equity interest. Consider whether the Bureau on remand seeks to add an argument that the notes in *Byker* are also "evidence of indebtedness" under MUSA.

In its 1966 decision in *Beam v. U.S.* the U.S. Court of Appeals for the Sixth Circuit found that a credit sales invoice used in a forgery scheme was not "evidence of indebtedness," and thus not a security, because it could not be negotiated and thus had no value in itself to the forger. In a 1991 federal trial court decision out of the W.D. of Michigan, *Tucker Freight Lines, Inc v. Walhout*, the court found that wage deferral agreements by employees to their company were neither notes nor evidence of indebtedness because they did not induce a reasonable expectation of profit like an investment does. Interestingly, the *Walhout* court in a parenthetical said the *Reves* test for notes "seems applicable to all debt instruments, including evidence of indebtedness." *Walhout* also applied the *Howey* test and held that the wage deferral agreements were not "investment contracts" because the employees did not expect profit from their agreements; they did not even expect interest payments in exchange for deferring their wages.

Finally, required reading on these issues is the 1996 opinion styled *Proctor & Gamble Co. v. Bankers Tr. Co*, issued by a federal trial court in Ohio, but written by the late federal trial court judge from Michigan, Hon. John Feikens. Judge Feikens skillfully applies *Reves, Howey*, and a test under the Ohio securities law similar to MUSA's 5-part test, to separately analyze whether the complex derivative swap agreements in that case were "notes," "evidence of indebtedness," or "investment contracts." Judge Feikens found that the swaps were not "investment contracts" under *Howey* because they did not involve pooling money in a common enterprise of another company. Nor were they investment contracts under the Ohio securities test because the profit to be earned from the swap contracts — which is based on interest rate fluctuations from a complicated formula tied to commercial paper interest rates — did not depend on the performance or management of an underlying enterprise. The swaps were not notes under the *Reves* test because they were not widely distributed, and the investors did not reasonably think the swap agreements were securities. In finding that the swaps were not "evidence of indebtedness," Judge Feikens cited back to *Walhout* when he said that "[t]he test whether an instrument is within the category of 'evidence of indebtedness' is essentially the same as whether an instrument is a note." The plaintiff argued the swaps were evidence of indebtedness "either because they may contain terms and conditions well beyond the typical terms of a note and beyond an ordinary

investor’s ability to understand, or because the debt obligation simply does not possess the physical characteristics of a note.” Judge Feikens rejected this “because that definition omits an essential element of debt instruments — the payment or repayment of principal.” And since swap agreements don’t involve the payment of principal — since the interest rate tied to the commercial paper never changes hands, only interest payments based on that amount do — the agreements can’t be evidence of indebtedness and thus can’t be securities subject to the federal and Ohio securities laws.

Outline of *Reves* Family Resemblance Test That is Now Michigan Law

Both the federal securities laws and MUSA expressly define a “note” as a “security.” After *Byker*, both federal and Michigan law presume that notes are securities, and the *Reves* test applies. Now, under *Reves*, the Michigan and federal presumption that a note is a security can be rebutted by a showing that the note “bears a strong resemblance” to the following list of notes which are not securities:

- Note delivered in consumer financing
- Note secured by a mortgage on a home
- Short term note secured by a lien on a small business or some of its assets
- Note evidencing a ‘character’ loan to a bank customer[1]
- Short term notes secured by an assignment of accounts receivable
- Note which simply formalizes an open-account debt incurred in the ordinary course of business
- Notes evidencing loans by commercial banks for current operations

The *Reves* Court developed four standards to determine whether an instrument “bears a strong resemblance” to the categories of loans above, or whether another category should be added to the list, sufficient to exempt the instrument from the definition of a security:

1. Assess the motivations of the buyer and seller

“If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a ‘security.’ If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a ‘security.’”

2. Examine the “plan of distribution” of the instrument

Courts will assess whether the loan sale is an “instrument in which there is ‘common trading for speculation or investment.’” If the notes are marketed to a broad segment of the public, then it is more likely that the SEC or a court will find that the note is a security.

3. Examine the reasonable expectations of the investing public

The Court will consider instruments to be 'securities' on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not 'securities' as used in that transaction." In other words, if the people to whom the notes are being sold consider them to be investments and "securities," then securities regulators or the court may weigh this factor in favor of considering the notes securities.

4. Existence of other regulatory schemes that protect the public

The existence of another regulatory scheme that "significantly reduces the risk of the instrument" may render "application of the Securities Acts unnecessary." *Reves*, 494 US at 67. "[T]he existence of collateral is significant as a risk-reducing factor," and notes secured by a mortgage "leads to the Note resembling a note secured by a mortgage on a home" under the *Reves* family resemblance test, thus leading courts to conclude that secured notes are not securities. *See Eagle Trim, Inc. v. Eagle-Pitcher Indus., Inc.* (ED Mich 2002).

[1] "Typically, character loans are offered by banks 'in an attempt to cement or maintain an ongoing commercial relationship with the borrower.' In determining whether to extend such loans, banks exercise considerable expertise in evaluating potential borrowers and the risks involved." *In re Goldsworthy*, SEC Release No. 45926, at *5 (May 15, 2002); *In re Stoiber*, SEC Release No. 39112 (Sept 22, 1997) ("Character loans, in particular, are generally given to longstanding large depositors, whose credit situation is known to the financial institution.").