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FAMILY RESEMBLANCE: WHEN IS A PROMISSORY NOTE NOT A "SECURITY"?

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For financing lawyers, the precise dividing line between the simple fluidity of financing law and the highly meticulous application of securities laws has always been an uncertain one. A good example of this uncertainty involves the issue of whether and when a promissory note issued in the course of a commercial financing will be treated as a "security." Specifically, when can a promissory note or other debt instrument be issued free of securities law concerns and when will it cross the line sufficiently to require strict adherence with such laws? The recent Ontario Court of Justice decision in Ontario Securities Commission v Tiffin[1] introduces a common sense approach to this question.

Factual Background

In Tiffin, a private company sought to raise funds from a handful of existing clients. All told, six clients extended $700,000 of debt financing on the strength of fourteen promissory notes, all of which were secured by a claim against certain assets. The notes bore varying rates of interest and were issued with a one-year maturity. Seemingly routine as far as small financings go, the transaction soon attracted the attention of the Ontario Securities Commission ("OSC"), not least because both the company and its chief executive were bound by existing orders prohibiting them from trading in securities. In due course, both were charged with breaching the existing order on the basis that the new company notes were "securities" under the Securities Act (Ontario) (the "Act").

The OSC argued that the Act covered virtually all promissory notes and other forms of debt instrument and suggested that the only way the company's new notes could avoid strict compliance with the Act was to find a suitable statutory exemption. Described as a "catch and exclude" system, the position effectively asserted initial jurisdiction over all commercial debt transactions in the province.

Context and Purpose are Key

Based on a literal interpretation, there was no doubt that the notes fell into the definition of "securities" as set forth in Section 1(1) of the Act. The Act plainly provides that a "security" includes any "note or other evidence of indebtedness". However, as in most cases, a strict literal approach to statutory interpretation is not appropriate. Since all legislation is enacted to deal with a specific concern, courts must first discern the purpose of the statutory provision in question and then interpret the words used so as to effectuate that purpose.

The Court in Tiffin noted that the twin objectives of the Act were to protect investors from unfair, improper or fraudulent practices and to foster fair and efficient capital markets. While stated broadly, the Court nevertheless found that the legislature's intent had not been to regulate all commercial debt transactions in the province. Specifically, securities laws were not meant to displace all other legal regimes. Echoing a caution expressed in the Supreme Court of Canada decision in Pacific Coast Coin Exchange Ltd. v Ontario (Securities Commission)[2], Justice Kenkel reiterated that courts should avoid overly broad interpretations of securities laws, lest such interpretations "bring within the scope of the Securities Act innumerable transactions which have no public aspect".

As a practical reality, promissory notes and other debt instruments are used in a whole range of financing situations. Examples include promissory notes issued in consumer financing, debentures issued in connection with a mortgage of real estate, notes or debentures secured by a lien on a business or specific assets of a business, personal notes issued to a financial institution, short term notes secured by a receivables assignment, and open account notes incurred in the ordinary course of business.

The point is that unlike shares of capital stock, which are sometimes said to be the "quintessence of a security", and thus justifiably require strict adherence with securities laws, certain promissory notes may possess a markedly different character.[3] Recognizing this distinction, the Court held that a purpose-based approach demanded a narrower reading of the statutory definition of "securities".

When Do Securities Laws Not Apply?

So when will promissory notes not constitute "securities" under a purpose-based approach? The Court adopted the "family resemblance test" put forward by the United States Supreme Court in Reves v Ernst & Young.[4] Under this test, every promissory

note is initially presumed to be a "security" unless it bears a strong resemblance to one of a judicially-crafted family of instruments that are not typically considered to be securities. The essence of the "family resemblance test" is one of context and purpose: were the notes in question issued in a purely commercial context or were they issued for investment purposes?

Four questions (or factors) are useful in making a suitable determination:

a. Is the purpose of the debt transaction to raise money for the general use of a business enterprise or to finance substantial investments and is the purchaser motivated primarily by the profit the notes are expected to generate for the business?
b. Does the issuer's plan of distribution seek to establish some form of common trading in the notes, either for speculative or investment purposes?
c. Is there a reasonable public expectation that the instruments should be treated as "securities"?
d. Is there some mitigating factor such as the existence of another regulatory scheme that sufficiently protects investors, thereby rendering strict application of securities laws unnecessary?

Affirmative answers to the first three questions or a negative answer to the last all tend to favour characterization of the promissory note as a "security". For example, the issuance of convertible debentures to a group of arm's length investors seeking both yield and possible future upside on conversion would likely be an example falling into the first category, while a corporate bond issuance made to investors looking for liquidity of investment in an anticipated secondary market might be an example falling into the second category. On the other hand, the issuance of debentures secured by one or more parcels of real estate in favour of a handful of lenders and without regard for a secondary market might not warrant treatment under securities laws.[5]

The End Result

In the end, the Court found that the company's notes were not "securities" under the Act because (i) the promissory notes were issued largely without regard to any future upside of the company, (ii) the promissory notes were secured against the company's assets, and thus more closely resembled a typical secured financing, with appropriate remedies on loan default which sufficiently protected the lenders, (iii) there was no expectation of a secondary market in the notes, and finally because (iv) the investors were existing clients of the company, already intimate with its affairs, and not members of the public,

suggesting that the transaction lacked a sufficiently public aspect for securities law application.

In summation, the "securities" determination in any given situation may be less than straight-forward. In many cases, specific securities law advice will be warranted. Nevertheless, the Tiffin case reminds counsel that a purpose-based approach is generally the appropriate one in most circumstances. Indeed, it may be just a question of family resemblance.

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[1] Ontario Securities Commission v Tiffin, (2016) 133 O.R.(3d) 341 (O.C.J.)
[2] Pacific Coast Coin Exchange Ltd. v Ontario (Securities Commission), [1978] 2 S.C.R. 112.
[3] Referring favourably to the judgment of the United States Supreme Court in Reves v Ernst & Young, 494 US 56 (1990).
[4] Reves v Ernst & Young, 494 US 56 (1990).
[5] See also the decision of the British Columbia Court of Appeal in British Columbia (Securities Commission) v Gill, 2003 BCCA 169, where the Court applied the Reves family resemblance test and found that loans there called "personal loans" did meet the definition of "security" for securities law purposes.

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