

## *Holy smoke, my promissory note's a security!*

The issuance of one or more promissory notes has been an unproblematic feature in many transactions. The basic legal regime for transfer and pledge of such instruments is well understood: If the note is negotiable, Articles 3 (“Commercial Paper”) and 9 (“Secured Transactions”) of the Uniform Commercial Code (UCC) govern; otherwise, it’s Article 9 and the common law (which is likely to draw on Article 3).

This past April the New York Court of Appeals (New York’s highest) upset those comfortable understandings. In *Highland Capital Management LP v. Schneider*, the court held that eight promissory notes issued to four individuals as partial payment for their business were securities governed by Article 8 (“Investment Securities”) of the UCC.

No one has ever doubted that some promissory notes — for example, those traded on securities exchanges — are also Article 8 securities. Indeed, Article 8 states that if an Article 3 promissory note also meets the requirements for an Article 8 security, then Article 8 governs. It is also widely understood that some promissory notes (and lots of other instruments as well) may be “securities” for purposes of the federal securities laws without being Article 8 securities. The UCC governs the commercial law aspects of notes and securities — primarily the rights and obligations of transferors, transferees, pledgors and secured parties — while federal and state securities laws govern the anti-fraud and disclosure aspects of sales of securities.

What happens when the commercial law rules for promissory notes suddenly shift from Article 3 (or comparable common law principles) to Article 8? Here are a few things to watch for (or worry about):

1 **Statute of frauds.** In New York and many other states that have not adopted the newest version of UCC Article 1, a sale of promissory notes is subject to the statute of frauds; a sale of Article 8 securities is not. (This was the difference that led the plaintiff’s lawyers in *Highland Capital* to argue that the notes were governed by Article 8.)

2 **Endorsement.** Notes and securities certificates are both transferred by endorsement, but Article 3’s default rules differ from Article 8’s. Under Article 3, an endorser of a promissory note also guarantees that if the instrument is dishonored, the endorser will pay it in accordance with its tenor; an endorser of an Article 8 security makes no such undertaking. Of course, these are just default rules. An endorser of an Article 3 instrument can negate the guaranty by writing “without recourse” above his or her signature, just as an endorsement of an Article 8 security can include specific words of guaranty.

Notes can be transferred more than once, with each endorser warranting to later holders that the prior endorsements are genuine. The endorser of a security does not make these warranties, primarily because securities are generally not transferred via a string of endorsements. Which brings us to the next difference between notes and securities.

3 **Registration of transfer.** Generally, when a security certificate is transferred, the transferee will deliver the endorsed certificate to the issuer or its transfer agent, who will issue a new certificate in the transferee’s name. Indeed, Article 8 mandates that the issuer register transfer. So an issuer of promissory notes that are found to be securities will be obliged to register the transfer and issue new notes/securities upon a transferee’s request.

4 **Restrictions on assignment.** Article 9 makes some restrictions on the assignment of promissory notes ineffective, but these rules do not apply to securities.

5 **The great unknown.** Articles 3 and 8 differ in many other points that may prove critical in particular situations. Whether these differences will have a profound effect on market practices is not yet clear. Expect some surprises.

Despite *Highland Capital*, you may be able to keep your promissory notes under the comforting shelter of Article 3. Primarily, *Highland Capital* depended on identical notes (except for amount) being issued to different payees. If your transaction doesn't involve identical notes, you should have no worry. But if it does, you might consider changing some of the less important terms so that no two notes are alike.

You might also consider removing the issuer from the transfer process. The notes in *Highland Capital* had legends to the effect that they could only be transferred if a Securities Act registration statement was in effect, or the issuer received an opinion that registration was not required. These requirements seem to have been critical to the *Highland Capital* court's decision. If you can do without such requirements, you're probably safe.

There was a presentation on the earlier decisions in the *Highland Capital* litigation at the Spring 2007 meeting of the Business Law Section; materials are available at [http://meetings.abanet.org/webupload/commupload/CL190000/otherlinks\\_files/int6D.DOC](http://meetings.abanet.org/webupload/commupload/CL190000/otherlinks_files/int6D.DOC). An analysis of the New York Court of Appeals decision will appear in *The Business Lawyer's* annual UCC roundup, scheduled for the August 2007 issue.

Howard Darmstadter  
New York City