THRIFT NOTES IN GEORGIA

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For the purpose of this article thrift notes are defined as unsecured, unregistered, corporate promissory notes, marketed in recent years by Georgia-domiciled corporations through newspaper advertisements (and sometimes through radio and television commercials), and sold to Georgia residents only.

On February 6, 1974, North American Acceptance Corp. (NAAC), a firm largely responsible for popularizing the term "thrift note" in its advertisements, filed for protection under Chapter 11 of the Federal Bankruptcy Act.[1] Soon thereafter, District Judge Newell Edenfield "granted a change to Chapter 10 . . . ."[2]

On February 14, Institutional Investments Ass'n Inc., also filed for a Chapter 11 "arrangement."[3] On February 21, the firm consented to a Securities and Exchange Commission (SEC) order "forbidding future fraud in sales practices."[4]

Also on February 21, the SEC filed charges of "fraudulent sales practices in public offerings" of securities issued by Allstate Leasing & Acceptance Corp. (a Doraville, Ga. firm, not affiliated with Sears).[5] On February 26, Allstate "consented to a federal court order appointing a receiver to take control of the business."[6]

Currently, all of these cases are under court review. It would be improper for us to second-guess the district court on final determination of these matters. Rather, we shall explore the interface of law and business with respect to so-called thrift notes, noting subtle interrelationships these notes have highlighted between (1) government's role as referee and promoter of ethical business conduct, (2) investors' searching for profitable employment of their savings, and (3) business' financing practices.

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1. Carlan, Atlanta Constitution, Feb. 7, 1974, at 1-A, col. 5.
2. Cutts, Atlanta Constitution, Mar. 7, 1974, at 31-A, col. 3.
3. Lorenz, Atlanta Journal, Feb. 15, 1974, at 2-A, col. 1; Cutts, Atlanta Constitution, Feb. 16, 1974, at 2-A, col. 5.
4. Cutts, Atlanta Constitution, Feb. 22, 1974, at 19-A, col. 1.
5. Cutts, Atlanta Constitution, Feb. 21, 1974, at 22-A, col. 4.
6. Lorenz, Atlanta Journal, Feb. 26, 1974, at 2-A, col. 1. (*See also* Cutts, Atlanta Constitution, Feb. 27, 1974, at 15-A, col. 1.

I. Regulation and the Investment Process

The purpose of the Securities Act of 1933, as stated in its preamble, was "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof . . . ."[7] But, in the words of a noted authority, "[i]t should be pointed out that the SEC is not concerned with the investment value of the securities being issued, only with the presentation of complete and accurate information."[8]

The 1933 Act exempted from registration requirements securities "offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory."[9] But the key words "resident within" and "doing business within" have been subject to much judicial debate. Recently, the SEC further clarified these terms through its new Rule 147, effective March 1, 1974, making exemption from federal registration contingent upon a firm's deriving at least 80% of its gross revenues from operations conducted within a single state or territory.[10]

The Georgia Securities Act of 1957 granted exemption from state registration to "negotiable instruments maturing in not more than twelve months from date of issuance."[11] It also made it unlawful "either directly or indirectly (1) to employ any device, scheme or artifice to defraud, or (2) to engage in any act, practice, transaction or course of business which operates or would operate as a fraud or deceit upon the purchaser or seller" of securities.[12] Section 19(b) of the Securities Act of 1933[13] permits the SEC to investigate fraud practiced "by the use of the mails, directly or indirectly . . . ."[14]

However, securities regulations, and securities registration, whether state or federal, have not eliminated all securities frauds, nor can they do so, as the Equity Funding and United States National Bank of San Diego collapses have shown. In addition, legislation cannot eliminate investment risk in securities untouched by fraud, as widespread plunges in stock market values have recently demonstrated.

Investors utilize financial intermediaries for convenience and for safety. Financial intermediation is a process whereby the investor selects a third party, normally a financial institution, to channel his funds and the funds

7. 48 Stat. 74 (1933).
8. J. Van Horne, Financial Management and Policy 317 (1974).
9. 15 U.S.C. §77c(a)(11) (1970).
10. 39 Fed. Reg. 2357 (Jan. 21, 1974).
11. Ga. Code Ann. §97-106(g) (Rev. 1968).
12. Ga. Code Ann. §97-112(b) (Rev. 1968).
13. 15 U.S.C. §77(s)(b) (1970).
14. 15 U.S.C. §877(q) (1970).

of other savers to some ultimate borrower. By pooling the funds of many investors, by diversification of investments, and possibly through its own financial expertise, the intermediary might lessen risk and/or increase earnings for individual investors. Also, in the case of insured savings deposits, investors get both safety of principal and certainty of returns.

A subtle feature of government regulation probably contributed to investors' attraction to thrift notes. Regulatory authorities impose a ceiling on the rates of interest federally insured commercial banks and savings and loan associations may pay on consumer-type savings instruments.[15] Such regulation is intended to protect financial intermediaries from "excessive" and "ruinous" rate competition and to promote low-cost home financing. But in recent years of frequent tight monetary policy and soaring interest rates, it has also led to increased investor interest in higher-yielding, uninsured investments, a phenomenon often termed "financial disintermediation."

While the specific terms of thrift notes varied from firm to firm, and with respect to the different issues of a given firm, basically they were unsecured, available in small denominations in maturities of nine months or less (some were payable on demand), and sold to "Georgia residents only." Thus, they were freed from both Georgia and federal registration requirements, a significant cost saving for the issuers.

Doubtless some of these notes were purchased by naive investors, whose predicament today is understandably grievous. But many thrift note purchasers were knowledgeable, recognizing but underestimating the degree of risk inherent in their investments.[16]

Thrift note issuers increased their own financial risk if they relied heavily on selling notes payable on demand. Very few enterprises, even banks and savings and loan associations, could meet all of their liabilities at once without emergency credit sources. That is why the Federal Reserve System and the Federal Home Loan Bank System are empowered to act as lenders of last resort should their member institutions experience "runs" similar to those occurring during the 1930's. The avoidance of runs is also a sound reason for the deposit insurance provided by FDIC and FSLIC.

NAAC's inability to meet all of its demand obligations seems to have precipitated runs on other thrift note issuers. In contrast, since depositors in insured banks know that their funds are federally insured, a run on one bank need not trigger runs on other banks. In fact, with deposit insurance

15. Regulation Q of the Board of Governers, Federal Reserve System, governs banks that are members of the System. 12 C.F.R. §217 (Supp. 1974). Ceiling rates are imposed on other insured banks by the Federal Deposit Insurance Corporation. 12 C.F.R. § 329 (Supp. 1974). The Federal Home Loan Bank Board imposes rate ceilings on insured savings and loan associations. 12 C.F.R. §526 (Supp. 1974).

16. Even some state educational money was invested in thrift notes, by the Pioneer Cooperative Education Services Agency (representing 14 North Georgia School Systems). *See* Atlanta Journal, Feb. 27, 1974, at 15-A, col. 1.

in effect, even the outright failure of a bank normally results in little or no run on that bank itself.[17]

II. Recent Legislation and Comment

Section 13-204.2 of the Georgia Code, adopted in 1973 as a supplement to the state's banking laws, forbids advertising that would induce investors to believe that so-called thrift notes are as risk-free as federally insured savings deposits. Under this section, terms such as "savings," "savings account," "deposit," or "withdrawal" cannot be used in advertisements for such notes. It might be wise, however, to strengthen this section by requiring that future thrift note advertisements include a statement such as: "Not insured by any governmental agency," or similar wording. But our survey in late March revealed, paradoxically, that Atlanta's two largest commercial banks were issuing savings account passbooks that contained no mention of FDIC protection.[18]

Section 8(j) of the Georgia Securities Act of 1973, successor to the 1957 Act, became effective on April 1, 1974, and exempts short-maturity securities from registration only if "said securities are not offered for sale by means of advertisements publicly disseminated in the news media or through the mails . . . ."[19] This provision was obviously prompted by suspected abuses by thrift note issuers, and it will clearly force such issuers to obtain state registration in the future.

But in securing such registration, the General Assembly has forced every Georgian, even the corner grocer who wishes to raise a little money through a classified ad in his local newspaper's "Wanted to Borrow" column, to register his offering. Sooner or later, some form of exemption will probably be enacted to exclude from registration requirements such a family business with modest financing needs.

For non-exempt securities, the Georgia Securities Act of 1973 requires that registration with the Commissioner of Securities be accompanied by the furnishing of a meaningful prospectus to each interested investor. Section 6(j) of this Act requires registered note issuers to promptly file quarterly and annual financial statements with the Commissioner, but does not require mailings of these reports to the companies' securities holders.[20]

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17. Insured institutions are seldom permitted to dissolve, but rather are reorganized or merged with a sound institution, under supervision of the insuring agency. But the recent failure of United States National Bank "has pointed up some regulatory conflicts between federal agencies in charge of protecting bank depositors and the Securities and Exchange Commission whose goal is to protect stockholders." Gapay, *San Diego Bank Failure Evidences Discord Between Banking Regulators and the SEC,* Wall Street Journal, Nov. 9, 1973, at 17, col. 1.

18. For a discussion of recent depositor losses on uninsured savings deposits, see Paulson, *Uninsured Accounts are Potentially a Rainy Day for Savers,* National Observer, Dec. 15, 1973, at 1, col. 1.

19. Ga. Laws, 1973, p. 1202 at 1240.

20. *Id.* at 1235-37.

We suspect that few of these investors would travel at their own expense, and on a regular basis, to view these financial statements at the State Capitol. Required mailings, similar to federal provisions, would provide a more continuous flow of relevant information.

In February, 1973, NAAC began to market two-to-five-year notes that, consequently, required state registration and the issuance of a prospectus. That prospectus warned of serious problems facing the company, but few thrift note investors ever saw it. Georgia law did not require its distribution to short-term noteholders.

III. Conclusion

We cannot outlaw all investment risks in a healthy, free-enterprise economy. If anyone has been defrauded in thrift notes, the courts are empowered to exact punishment and/or assess monetary compensation.

Much of the investor risk in thrift notes was quite subtle. It stemmed from the demand feature of many of the securities, a factor conducive to runs on enterprises that might otherwise be sound and profitable. Unfortunately, anticipation of such subtle risks requires investor sophistication, something that cannot be legislated.