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## LOAN PARTICIPATION AGREEMENTS AS SECURITIES: JUDICIAL INTERPRETATIONS OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934

The use of multibank financing has increased greatly in recent years.<sup>1</sup> Because of the cost and complexity of many financial ventures, a single bank may be unable or unwilling to loan all the funds required. One solution is the loan participation agreement, in which participant banks purchase a share of a loan made by a lead bank in return for a corresponding share of the borrower's principal and interest payments.<sup>2</sup> If the borrower defaults on the loan, a participant bank may sue the lead bank for fraud alleging that the loan participation agreement is a security under the Securities Act of 1933<sup>3</sup> (the 1933 Act) or the Securities Exchange Act of 1934<sup>4</sup> (the 1934 Act). Because lead bank liability is more probable under the Securities Acts than under the common law,<sup>5</sup> whether loan participation agreements are securities is a vital

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1. See Note, *The Colocotronis Dispute: When is a Loan Participation Share a Security?*, 13 J. INT'L LAW & ECON. 165, 169 (1978).

2. For a discussion of loan participation agreements, see *infra* notes 6-21 and accompanying text.

3. 15 U.S.C. §§ 77a - 77aa (1976 & Supp. IV 1980).

4. 15 U.S.C. §§ 78a - 78kk (1976 & Supp. IV 1980).

5. A plaintiff must show deceit to recover under the common law. Prosser describes the elements of deceit as a false representation made by the defendant, knowledge or belief by the defendant that the representation is false, an intention to have the plaintiff rely upon the misrepresentation, justifiable reliance by the plaintiff, and damages from such reliance. W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 105 (4th ed. 1971). Moreover, the plaintiff must be in privity with the defendant, and omissions of material fact are not actionable unless the defendant has a duty to speak. *Id.* §§ 105-106.

Conversely, the Securities Acts do not require an intent to deceive in all cases. *Aaron v. SEC*, 446 U.S. 680, 689-702 (1980). The Acts expressly cover material omissions. Securities Act of 1933, §§ 11, 12, 17, 15 U.S.C. §§ 77k, 77l, 77q (1976); Securities Exchange Act of 1934, § 10b, 15 U.S.C. § 78j (1976). Additionally, the Acts relax the reliance, causation, and privity elements. *Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith Inc.*, 495 F.2d 228 (2d Cir. 1974). Finally, the process provisions in a suit under the Securities Acts are more expansive than under the Federal Rules of Civil Procedure. Compare Securities Act of 1933, §§ 20, 22, 15 U.S.C. §§ 77t, 77v (1976) and Securities Exchange Act of 1934, §§ 21, 27, 15 U.S.C. §§ 78u, 78aa (1976 & Supp. IV 1980) with Fed. R. Civ. P. 4(f). See generally Hammett, *Any Promissory Note: The Obscene Security, A Search for the Non-Commercial Investment*, 7 TEX. TECH. L. REV. 25, 30-36 (1975).

question. This Note will examine the statutory and judicial definitions of a security and will conclude that loan participation agreements often are securities.

### LOAN PARTICIPATIONS

In a loan participation, the lending or "lead" bank sells undivided fractional interests in a loan to any number of "participating" banks.<sup>6</sup> A loan participation is similar to a loan syndication in that a group of banks provides funds to a borrower.<sup>7</sup> In a loan syndication, however, each bank signs the loan agreement with the borrower and receives a note representing its share of the indebtedness, and thus has a separate and distinct legal relationship with the borrower.<sup>8</sup> Conversely, in a loan participation, the lead bank alone deals directly with the borrower and retains all the loan documentation, including the borrower's note representing the entire amount borrowed. The participating banks are involved solely with the lead bank and have no rights directly against the borrower.<sup>9</sup>

The lead bank negotiates the terms of the loan with the borrower and concludes the lending agreement. To arrange the loan participation, the lead bank prepares a "placement memorandum" which sets forth the financial condition of the borrower. The lead bank then solicits other banks' participation. The prospective participants may not receive any information other than the place-

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6. See generally V. DiLORENZO, W. SCHLICHTING, T. RICE & J. COOPER, *BANKING LAW* § 102.06 (1981) [hereinafter cited as DiLORENZO]; G. MUNN, *ENCYCLOPEDIA OF BANKING AND FINANCE* 572 (7th ed. 1973); Armstrong, *The Developing Law of Participation Agreements*, 50 J. COM. BANK LENDING 45 (1968); Thuleen, *Survey of Practice and Procedure of Banks in Taking Participations from Correspondent Banks*, 50 J. COM. BANK LENDING 10 (1968); Note, *Bank Loan Participations: The Affirmative Duty to Disclose under SEC Rule 10b-5*, 27 SYRACUSE L. REV. 807, 807-10 (1976).

Finance companies also may deal in loan participation agreements. See Comment, *Bank Loan Participations as Securities: Notes, Investment Contracts, and the Commercial/Investment Dichotomy*, 15 DUQ. L. REV. 261, 263 (1976-1977).

7. For a discussion of loan syndications, see generally DiLORENZO, *supra* note 6, § 102.07; Note, *Liabilities of Lead Banks in Syndicated Loans under the Securities Acts*, 58 B.U.L. REV. 45, 45-47 (1978).

8. Note, *supra* note 7, at 45-46.

9. The lead bank is the only secured party in the loan agreement and is the sole payee of the borrower's notes. The participating banks are not creditors of the borrower and "[u]pon any default by [the borrower, the lead] alone, [has] the power to act respecting such default or defaults." *In re Yale Express Sys., Inc.*, 245 F. Supp. 790, 792 (S.D.N.Y. 1965).

ment memorandum until after they have accepted the offer to participate.<sup>10</sup> For arranging the loan participation, the lead bank receives an initial commitment fee from the borrower;<sup>11</sup> additionally, the lead bank charges the participant banks a fee for managing the loan and funneling funds and information from the borrower to the participant banks.<sup>12</sup>

Each participant bank receives a certificate as evidence of the loan participation from the lead bank.<sup>13</sup> This document sets forth the terms of the loan participation agreement, including a disclaimer of lead bank liability for the loan if the borrower defaults<sup>14</sup> and a provision that limits the lead bank's liability for any losses arising from its mismanagement of the loan or the loan participation.<sup>15</sup> The lead bank also may warrant the authenticity of any documents it gives the participating banks.<sup>16</sup>

A bank may desire to sell participations in its loans for many reasons. A prospective borrower may have requested more funds than the bank has available, forcing the bank to seek other sources of funds to satisfy the borrower. The bank may be at its legal lending limit to a single borrower and, absent a loan participation, unable to make the loan.<sup>17</sup> A loan participation also spreads the risks of default and may improve the liquidity of the lead bank.<sup>18</sup> Additionally, a loan participation creates a mechanism for the lead bank to raise additional funds in the future if needed by the bor-

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10. *United Am. Bank of Nashville v. Gunter*, 620 F.2d 1108, 1112 (5th Cir. 1980).

11. The lead bank generally receives a commitment fee of at least .25% per annum of the unused portion of the loan. Comment, *The Qualification of Loan Participations as Securities — The Potential for Lead Bank Liability under Rule 10b-5 and Section 12(2): An Impact with International Ramifications*, 8 CAL. W. INT'L L. REV. 510, 512-13 (1978).

12. *Id.*

13. For examples of participation certificates, see Thuleen, *supra* note 6, at 19-23.

14. *Id.* at 17-18.

15. Issac, *Loan Participations and the Securities Laws*, 58 J. COM. BANK LENDING 50, 50-52 (1975); Thuleen, *supra* note 6, at 17.

16. Thuleen, *supra* note 6, at 12.

17. The total indebtedness of a national bank is limited statutorily to the amount of its capital stock plus 50% of the unimpaired surplus fund, except for certain specified demands. 12 U.S.C. § 82 (1976). The obligations of a national bank to a single person, copartnership, association, or corporation are limited to 10% of the bank's capital stock and 10% of its unimpaired surplus fund. 12 U.S.C. § 84. A lead bank may avoid these limits by selling loan participations because the cash of the participating banks supplements the lead bank's assets. Note, *supra* note 1, at 172-73.

18. Simpson, *Loan Participations: Pitfalls for Participants*, 31 BUS. LAW. 1977 (1976).

rower. Finally, the lead bank maintains an exclusive relationship with the borrower in a loan participation instead of being on an equal footing with other banks, as in a loan syndication.<sup>19</sup>

Participating banks also benefit from a loan participation. A prospective participant may wish to invest temporarily idle funds. Loan participations also may be the only means by which smaller regional banks can become involved in larger and potentially more profitable financial ventures.<sup>20</sup> A bank without the necessary expertise to evaluate a loan proposal in a certain area can purchase a participation in the loan of a more knowledgeable bank.<sup>21</sup> For all parties loan participation agreements can be profitable ventures; however, the potential liability is large, especially if the Securities Acts cover the agreement.

### LOAN PARTICIPATION AGREEMENTS AS SECURITIES

Both the 1933 and 1934 Acts define a security. Section 2(1) of the 1933 Act states "unless the context otherwise requires [a security is] any note . . . investment contract . . . or any participation in . . . any of the foregoing."<sup>22</sup> Thus, a participation in a security

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19. Because the lead bank alone deals with the borrower in a loan participation agreement, the lead bank is less likely to lose clients to other banks than in a loan syndication. Participating banks generally do not contact the borrower at any time without the lead bank's approval. Thuleen, *supra* note 6, at 13. A loan participation also is easier to manage. The syndication agreement may require the lead bank to obtain the consent of the syndicate members before taking action; in a loan participation, however, the lead bank generally controls the participation. Note, *supra* note 1, at 173.

20. Many loan participations originate in the correspondent banking system in which a "city" bank agrees to perform services such as check clearing for a "country" bank in return for interbank deposits. J. CLARKE, H. BAILEY & R. YOUNG, *BANK DEPOSITS AND COLLECTIONS* 10 (4th ed. 1972). A participation sold by a "country" respondent to a "city" correspondent is an "upstream" participation, and a participation from the correspondent bank to the respondent bank is a "downstream" participation. Stivers, *An Analysis of the Techniques Utilized to Meet the Loan Participation Needs of a Correspondent Bank*, 53 J. COM. BANK LENDING 31 (1970).

21. One area in which a bank may lack expertise is international financing. For a discussion of international loan participations and syndications, see Note, *International Loan Syndications, the Securities Acts, and the Duties of a Lead Bank*, 64 VA. L. REV. 897 (1978).

22. The 1933 Act states:

When used in this title, unless the context otherwise requires . . . [a security is] . . . any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transfer-

also is a security. The definition of a security in section 3(a)(11) of the 1934 Act is similar, but excludes notes which mature in nine months or less.<sup>23</sup> The 1933 Act exempts notes maturing in nine months or less from the Act's registration requirements,<sup>24</sup> but not from any antifraud provisions.<sup>25</sup> Under the 1934 Act's definition of a security, however, notes maturing in nine months or less literally are subject to neither the registration<sup>26</sup> nor the antifraud<sup>27</sup> provisions of the 1934 Act because such notes are not securities. Despite these differences, the United States Supreme Court stated that the definitions of a security in both Acts are virtually identical and should be interpreted similarly.<sup>28</sup>

Loan participation agreements may be securities in one of three ways. If the note underlying the loan participation is a security, the loan participation agreement also is a security.<sup>29</sup> The underlying loan may constitute an investment contract and again any par-

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able share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1976).

23. The 1934 Act states:

When used in this chapter, unless the context otherwise requires . . . [t]he term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security;" or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant, or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1976).

24. Section 3(a)(3) of the 1933 Act, 15 U.S.C. § 77c(a)(3) (1976) exempts such notes from the registration required under § 5 of the Act, 15 U.S.C. § 77e (1976).

25. The antifraud provisions of the 1933 Act include §§ 11, 12, 17, and 24. 15 U.S.C. §§ 77k, 77l, 77q, and 77x (1976).

26. Securities Exchange Act of 1934, § 12, 15 U.S.C. § 78l (1976).

27. Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78l (1976).

28. *Tcherepnin v. Knight*, 389 U.S. 332, 335-36 (1967).

29. *See infra* notes 32-99 and accompanying text.

ticipation in that loan is a security.<sup>30</sup> Finally, the loan participation agreement itself may be an investment contract, regardless of the status of the underlying transaction.<sup>31</sup> Not all loan participation agreements qualify as securities under the judicially devised tests for notes and investment contracts, but under certain circumstances, loan participation agreements are securities.

### *Notes Underlying Loan Participation Agreements As Securities*

The United States Court of Appeals for the Fifth Circuit considered the question of whether a note underlying a loan participation agreement is a security in *Lehigh Valley Trust Co. v. Central National Bank of Jacksonville*.<sup>32</sup> A participant bank, Lehigh Valley, sued the lead bank, Central, for alleged misstatements and omissions of material facts in violation of Rule 10b-5<sup>33</sup> and the 1934 Act.<sup>34</sup> Central argued that the loan participation agreement was not a security and thus not subject to the restraints of the securities laws. The court rejected Central's argument, applying a literal interpretation of the statutory definition of a security. Because the definition included "any note," the court reasoned that the borrower's note representing the underlying loan was a security.<sup>35</sup> The court stated that "this definition has been literally read by the judiciary to the extent that almost all notes are held to be securi-

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30. See *infra* notes 100-65 and accompanying text.

31. *Id.*

32. 409 F.2d 989 (5th Cir. 1969).

33. 17 C.F.R. § 240.10b-5 (1980). Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(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 business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

34. 409 F.2d at 990. Lehigh Valley also alleged that Central's misstatements and omissions constituted common law fraud under Florida law. The United States Court of Appeals for the Fifth Circuit affirmed the decision of the United States District Court for the Middle District of Florida in favor of Lehigh Valley on this issue. 409 F.2d at 993-94.

35. *Id.* at 992.

ties.”<sup>36</sup> The loan participation agreement itself was a security because it was a participation in a security, the note.<sup>37</sup>

The literal interpretation of a security in *Lehigh Valley* has not been followed, and even the Fifth Circuit has adopted another approach.<sup>38</sup> Courts seemingly did not believe that Congress intended the Securities Acts to be as expansive as a literal reading would indicate.<sup>39</sup> Instead of a literal approach, courts have emphasized the introductory phrase of the definitions of a security in both Securities Acts—“unless the context otherwise requires,”<sup>40</sup>—to restrict the definition of a security.<sup>41</sup>

Courts currently employ three tests to decide whether a note is a security. The majority approach is the commercial/investment dichotomy which attempts to determine the commercial or investment context of the transaction represented by the note.<sup>42</sup> Reasoning that Congress intended the Securities Acts to protect investors, courts applying the commercial/investment dichotomy hold that only investment notes are securities. The United States Court of

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36. *Id.* at 991-92.

37. *Id.* at 992. The court found no precedent dealing with the statutory phrase “any certificate of interest or participation in . . . a security,” but interpreted the phrase literally in view of the Supreme Court’s policy of broadly reading the statutory definition of a security to effectuate the antifraud provisions of the 1934 Act. *See SEC v. National Securities Inc.*, 393 U.S. 453, 464-69 (1969); *Tcherepnin v. Knight*, 389 U.S. 332, 338 (1967).

The court also rejected Central’s argument that Congress did not intend the Securities Acts to cover transactions between financial institutions because neither Congress nor the Securities and Exchange Commission had indicated that the unsophisticated and the unwary were the only wards of rule 10b-5; fraud also could be perpetrated upon powerful and sophisticated investors. 409 F.2d at 992. The court noted that *Lehigh Valley*, although sophisticated, was a small-town bank and had to rely upon Central’s representations concerning the soundness of the loan participation. *Id.* at 993.

38. *Bellah v. First Nat’l Bank*, 495 F.2d 1109 (5th Cir. 1974). *See infra* notes 52-55 and accompanying text.

39. One commentator argued that the courts’ dilemma arose “from an unwarranted refusal to believe that Congress understood the English language when it wrote the federal securities laws.” Hammett, *supra* note 5, at 74.

40. Securities Act of 1933, § 2(1) 15 U.S.C. § 77b(1) (1976); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1976).

41. *See* Hammett, *supra* note 5, at 74-75.

42. The United States Courts of Appeals for the Third, Fifth, Seventh, and Tenth Circuits employ the commercial/investment dichotomy. *See, e.g., C.N.S. Enter. v. G & G. Enter.*, 508 F.2d 1354, 1359-63 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); *Zabriskie v. Lewis*, 507 F.2d 546, 551-52 (10th Cir. 1974); *Bellah v. First Nat’l Bank*, 495 F.2d 1109, 1112-16 (5th Cir. 1974); *Lino v. City Investing Co.*, 487 F.2d 689 (3d Cir. 1973).

Appeals for the Ninth Circuit employs an analogous approach, the risk capital test.<sup>43</sup> If the note represents risk capital rather than merely a risky loan, the note is considered a security. Finally, the United States Court of Appeals for the Second Circuit, advocating a strict reading of the statutory language, follows a literalist interpretation.<sup>44</sup> Unless a note falls within one of six specified exceptions, it presumptively is a security.

### *The Commercial/Investment Test*

Under the commercial/investment dichotomy, only investment notes are securities. The test developed from a decision in *Lino v. City Investing Co.*<sup>45</sup> by the United States Court of Appeals for the Third Circuit. Lino bought two "Franchise Sales Center Licensing Agreements" from City Investing in return for cash and promissory notes. Lino sued City Investing for misstatements regarding the agreements, arguing that the promissory notes were securities.<sup>46</sup> In rejecting Lino's argument, the court seized upon the introductory phrase to the definitions of a security in both Securities Acts, "unless the context otherwise requires."<sup>47</sup> Reasoning that the phrase referred to the context of the transaction, the court held that Congress intended some transactions to fall outside the Securities Acts even though literally within the statutory definitions.<sup>48</sup> Lino made no public offering of the notes and City Investing did not procure them for speculation, investment, or venture capital. Due to the "commercial context" of this transaction<sup>49</sup> the court held that Lino's notes were not securities.<sup>50</sup>

Other courts followed the Third Circuit's rationale in examining the context of the transaction to determine whether a note is a

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43. *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976).

44. *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1138 (2d Cir. 1976).

45. 487 F.2d 689 (3d Cir. 1973).

46. *Id.* at 690-91.

47. *Id.* at 695.

48. *Id.* The court noted the Supreme Court's statement that "a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers." *Id.* (quoting *Holy Trinity Church v. United States*, 143 U.S. 457, 459 (1892)).

49. 487 F.2d at 694-95.

50. *Id.* at 696.

security.<sup>51</sup> The United States Court of Appeals for the Fifth Circuit explicitly set forth the commercial/investment dichotomy in *Bellah v. First National Bank*.<sup>52</sup> Stating that the 1934 Act "is for the protection of investors and must be read accordingly,"<sup>53</sup> the court held that the Securities Act covered only investment, not commercial, notes regardless of their maturity.<sup>54</sup> Because the bank loaned funds to the Bellahs merely to assist their business and not to profit directly from its operation, the note was part of an ordinary commercial transaction and not a security.<sup>55</sup>

Courts have examined a number of factors to distinguish investment from commercial notes, including the manner in which the notes were offered, the lender's reason for buying the notes, and the use to which the borrower put the money.<sup>56</sup> If the borrower

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51. See, e.g., *National Bank of Commerce v. All Am. Assurance Co.*, 583 F.2d 1295, 1301 (5th Cir. 1978); *Zabriskie v. Lewis*, 507 F.2d 546, 551 (10th Cir. 1974); *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 524-25 (5th Cir. 1974).

52. 495 F.2d 1109, 1112 (5th Cir. 1974).

53. *Id.* at 1111 (quoting *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 800 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973)).

54. 495 F.2d at 1112. Thus, the exclusion for notes maturing in nine months or less was effectively read out of the 1934 Act's definition of a security. See *supra* note 23 and accompanying text. In a later case, the Fifth Circuit admitted that such a conclusion might surprise the drafters of the statute:

We realize that our holding today that the [1934] Act does not apply to commercial notes of a longer duration than nine months, taken with the decisions voiding the short-term exemption as to investment paper, virtually writes that exemption out of the law. . . . [T]he investment or commercial nature of a note entirely controls the applicability of the Act, depriving of all activity the exemption based on maturity-length. The original scrivener of the definitional section may well wonder what happened to his carefully drawn exemption on the way to the courthouse, but if the judicial decisions do not properly reflect the intent of Congress as to the coverage of the Act, only that body can properly rectify that situation at this point, if *stare decisis* is to apply and the Supreme Court does not make some definitive decision contrary to the presently decided cases.

*McClure v. First Nat'l Bank*, 497 F.2d 490, 494-95 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975).

55. *Bellah v. First Nat'l Bank*, 495 F.2d at 1113-14. The court based its holding on congressional intent, stating that Congress did not intend securities laws "to render federal judges the guardians of all beguiled makers or payees." *Id.* at 1114. Furthermore, requiring registration of all commercial notes "inevitably [would] wreak havoc on the commercial paper market." *Id.* Such notes, however, usually would be exempt from registration under the private placement exemption. See Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2) (1976).

56. *McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975).

uses the money to promote a new enterprise<sup>57</sup> or rejuvenate a business<sup>58</sup> the note may be considered an investment. If the money is used for current business obligations, such as purchase of consumer goods, the transaction probably is commercial.<sup>59</sup> Another indicator is the method of measuring rate of return. If the rate is fixed, the note may be commercial; if the rate is tied to the success of the business, the note may be an investment.<sup>60</sup> Further, if the transaction is one in which stock often is given, the note probably is an investment.<sup>61</sup> Despite these attempts to formulate guidelines, no court has developed a single comprehensive test to distinguish commercial from investment notes.<sup>62</sup>

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57. *Zabriskie v. Lewis*, 507 F.2d 546, 551 (10th Cir. 1974).

58. *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 526-27 (5th Cir. 1974).

59. *Id.* at 526.

60. *Id.*

61. 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, 501 (1973), cited in *Zabriskie v. Lewis*, 507 F.2d 546, 551 (10th Cir. 1974).

62. A frequently cited Comment suggests six considerations to determine whether a note is commercial or investment in nature: common expectation, use of the proceeds, risk, number of payees and dollar amount of transaction, time, and how the note is characterized on financial statements. Comment, *supra* note 61, at 510-24.

The SEC defined commercial paper in SEC Securities Act Release No. 33-4412:

The legislative history of the [1933] Act makes clear that section 3(a)(3) applies only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks.

SEC Securities Act Release No. 33-4412 (Sept. 29, 1961), 26 Fed. Reg. 9159 (1961) (considering the registration exemption under § 3(a)(3) of the 1933 Act). The United States Court of Appeals for the Seventh Circuit used this definition of the 1933 Act's registration exemption to explain the 1934 Act's definition of a security, which excludes short-term notes. *Sanders v. John Nuveen & Co.*, 463 F.2d 1075, 1078-81 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972).

Other courts have held that the SEC Release applies only to the registration exemption and has no effect on the antifraud provisions of the Securities Acts. *See, e.g., Tri-County State Bank v. Hertz*, 418 F. Supp. 332, 339 (M.D. Pa. 1976). The SEC Release supports this conclusion:

It should be emphasized that section 3(a)(3), if available, affords an exemption only from the registration and prospectus requirements of section 5 of the [1933] Act and that civil liabilities of section 12(2) of the Act and the anti-fraud provisions of section 17 of the Act are still applicable.

SEC Securities Act Release No. 33-4412 (Sept. 29, 1961), 26 Fed. Reg. 9159 (1961). Courts have given no reason for using one Act's registration exemption to explain another Act's definitional exclusion. *See Sonnenschein, Federal Securities Law Coverage of Note Trans-*

The major problem with the commercial/investment dichotomy is its lack of precision. Courts consider different factors in every case and no one factor is determinative. Each case is decided on its own facts, causing unpredictability and confusion. The line between commercial and investment notes often is hazy, because one note may possess both commercial and investment characteristics.<sup>63</sup> The United States Court of Appeals for the Seventh Circuit, which employs the commercial/investment dichotomy, recognized the test's shortcomings in *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*<sup>64</sup>

In one sense every lender of money is an investor since he places his money at risk in anticipation of a profit in the form of interest. Also in a broad sense every investor lends his money to a borrower who uses it for a price and is expected to return it one day . . . . In between [the extreme cases] is a grey area which, in the absence of further congressional indication of intent or Supreme Court construction, has been and must be in the future subjected to case-by-case treatment.<sup>65</sup>

Another difficulty with the commercial/investment dichotomy is the Supreme Court's indication that courts must interpret the Securities Acts broadly to effect their remedial purpose.<sup>66</sup> The Securities Acts cover diverse forms of financing and do not stop with the ordinary and the commonplace.<sup>67</sup> The commercial/investment dichotomy, however, restricts the scope of the Securities Acts by defining investment too narrowly. The Supreme Court has held that an investment is a contribution of money to another to share in the expectation that the other will make money through its use.<sup>68</sup> Many notes, therefore, that are not investments under the commercial/investment dichotomy satisfy the Supreme Court's definition of an investment.<sup>69</sup>

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actions: *The Antifraud Provisions*, 35 Bus. Law. 1567, 1574 (1980).

63. A note may have both investment and commercial characteristics if it is a long-term note arising out of a pre-existing customer relationship.

64. 508 F.2d 1354 (7th Cir.), cert. denied, 423 U.S. 825 (1975).

65. *Id.* at 1359.

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

67. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).

68. SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946).

69. The Securities Acts protect not only investors, but also the capital market of the free

Thus, under the commercial/investment dichotomy, the note underlying a loan participation agreement may be a security if the note is an investment note.<sup>70</sup> The note is a security if it qualifies as an investment or if the borrower uses the funds to promote a new business, or construct or buy capital assets. Any participation in that note also is a security. A note falling under the "commercial" side of the dichotomy is not a security and is not governed by the Securities Acts.<sup>71</sup>

### *The Risk Capital Test*

The risk capital test<sup>72</sup> attempts to distinguish between risk capital and a risky loan.<sup>73</sup> A note is a security only if it represents risk capital. Indebtedness made upon the reasonable assumption that it will be repaid is a loan, while money put to the risk of the business is capital.<sup>74</sup> In *Great Western Bank & Trust v. Kotz*,<sup>75</sup> the United States Court of Appeals for the Ninth Circuit examined whether a lending bank could recover under the Securities Acts for losses suffered on an unsecured note received under a loan agreement. The ultimate inquiry in this case was whether the lender contributed risk capital subject to the managerial efforts of the borrower.<sup>76</sup>

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enterprise system. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975). By determining only whether a note represents an investment and not its place in the capital market, the commercial/investment dichotomy misconstrues congressional intent.

70. *First Fed. Sav. and Loan Ass'n v. Mortgage Corp.*, 467 F. Supp. 943 (N.D. Ala. 1979), *aff'd*, 650 F.2d 1376 (5th Cir. 1981), involved 20-year notes purchased by the lender to finance apartment and hotel construction. In a transaction similar to a loan participation agreement, the developer borrowed money for interim financing. The lender then sold the loan package to First Federal while continuing to administer the loan. The court held that the transaction was a sizeable business investment on the part of First Federal, and therefore the notes were securities. *Id.* at 950.

71. A loan participation in a commercial note, however, may be a security. *See infra* notes 100-86 and accompanying text.

72. The risk capital test originated in *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961), in which the California Supreme Court held that memberships in a country club were securities under California law. *See also* *Hawaii Comm'r of Sec. v. Hawaii Mkt. Center*, 52 Hawaii 642, 485 P.2d 105 (1971); *State ex rel. Healy v. Consumer Bus. Sys., Inc.*, 5 Or. App. 19, 482 P.2d 549 (1971).

73. *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252, 1257 (9th Cir. 1976).

74. *Cuyana Realty Co. v. United States*, 382 F.2d 298, 301 (Ct. Cl. 1967).

75. 532 F.2d 1252 (9th Cir. 1976).

76. *Id.* at 1257. The risk capital test includes an element of the *Howey* test for an investment contract: whether the funds are subject to the efforts of others. *SEC v. W.J. Howey*

The court listed six factors that determine whether a note represents risk capital and thus is a security:<sup>77</sup> the length of time of the obligation,<sup>78</sup> collateralization,<sup>79</sup> the form of the obligation,<sup>80</sup> circumstances of issuance,<sup>81</sup> the relationship between the amount borrowed and the size of the borrower's business,<sup>82</sup> and the contemplated use of the proceeds.<sup>83</sup> Applying these factors to the note, the court concluded that it was not a security. The note matured in ten months and the borrower had to maintain a checking account balance of at least \$300,000 with Great Western which constituted partial security. The note referred to the parties as "borrower" and "lender," the form of a typical lending agreement. Finally, Great Western restricted the borrower's use of the funds.<sup>84</sup> The court concluded that "[a] note given to a bank in the course of a commercial financing transaction is not generally a security within the meaning of the federal securities acts."<sup>85</sup>

The Court of Appeals for the Ninth Circuit applied the risk capital test to a put letter, similar to a loan participation, in *United California Bank v. THC Financial Corp.*<sup>86</sup> The court admitted that some notes underlying loan participation agreements were securities under the risk capital test: "[P]articipations or notes evi-

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Co., 328 U.S. 293 (1946). For a discussion of the *Howey* test, see *infra* notes 100-41.

77. 532 F.2d at 1257-58.

78. This factor is the most important; the longer the funds are used, the greater the risk. *Id.*

79. The lender is more dependent upon the skills of the borrower of unsecured notes than of secured notes. *Id.*

80. This factor assists in explaining the circumstances of the obligation's issue. *Id.*

81. If the note is issued to a large group rather than to a single party, the note is more likely to be an investment. *Id.*

82. The larger the relative amount, the greater the risk to the lender. *Id.*

83. Under this factor, the court must determine whether the funds are for higher risk enterprise formation or lower risk current financing. *Id.*

84. *Id.* at 1258-60.

85. *Id.* at 1260. The Supreme Court mentioned the risk capital test but refused to rule upon its validity because that issue was not raised in the case. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 857 n.24. For another application of the risk capital test, see *Amfac Mort. Corp. v. Arizona Mall, Inc.*, 583 F.2d 426 (9th Cir. 1978).

86. 557 F.2d 1351 (9th Cir. 1977). Under the put letter, United California Bank agreed to extend a \$500,000 line of credit to Climate Company if THC Financial Corporation consented to buy from United California Bank all the notes that Climate gave to secure the loans. THC Financial then would have received an assignment of Climate's Hawaii receivables. For the text of the agreement, see *id.* at 1354 n.1.

dencing 'risk capital', i.e., risk of nonpayment, are securities while those evidencing 'risky loans' are not."<sup>87</sup> Thus, a note representing risk capital and any participation therein are securities.

Although somewhat more specific than the commercial/investment dichotomy, the risk capital test suffers from similar infirmities. First, the test is not comprehensive, as evidenced by the court in *Kotz* stating that it may consider other factors in other cases.<sup>88</sup> The test also lacks predictability and guidance as to its application in individual cases. The United States Court of Appeals for the Ninth Circuit never indicated the level of risk required by the test for a note to be a security and how the different factors interrelated. Additionally, the test fails to distinguish personal loans to consumers from supposed "investment" transactions.<sup>89</sup> Another problem with the risk capital test is its suggestion that the status of a note may depend upon the financial situation of the drawer, because the risk of nonpayment increases in proportion to the financial insecurity of the drawer.

### *The Literalist Test*

The United States Court of Appeals for the Second Circuit employs a more literal approach to the issue of whether notes are securities. Reasoning that the statutory language is clear, the court initially presumes all notes are securities. In *Exchange National Bank of Chicago v. Touche Ross & Co.*,<sup>90</sup> the court held that a broker's unsecured notes purchased by the bank were securities under the 1934 Act. The court discussed and rejected the tests advanced by the other courts of appeals. According to the court, neither the commercial/investment dichotomy nor the risk capital test provided adequate standards for uniform application, because both tests required applying a variety of ill-defined factors without providing instructions as to relative weights.<sup>91</sup>

The court agreed with other circuits that the introductory

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87. *Id.* at 1358.

88. 532 F.2d at 1258.

89. A personal loan still may qualify as a security under the risk capital test. *Id.* For a discussion of factors that may characterize a personal loan as a security, see *supra* notes 78-83 and accompanying text.

90. 544 F.2d 1126 (2d Cir. 1976).

91. *Id.* at 1137.

phrase of both Securities Acts' definitions of a security, "unless the context otherwise requires," limited the scope of the definitions. Yet the court held that the phrase referred to the purposes underlying the Securities Acts, not the investment or commercial context of the individual transactions.<sup>92</sup>

Although the Supreme Court, in *United Housing Foundation, Inc. v. Forman*,<sup>93</sup> advocated considering form over substance, the Second Circuit in *Exchange National Bank* stated that in the note context, "the best alternative now available may lie in greater recourse to the statutory language."<sup>94</sup> To exclude a note that literally is covered by the Securities Acts from the Acts' requirements, a party must show that the purpose of the Acts requires such an interpretation. The court listed six instances in which the Acts' purposes justified exclusion,<sup>95</sup> and reasoned that unless the note bears "a strong family resemblance"<sup>96</sup> to one of the exceptions and has a maturity exceeding nine months, the 1934 Act usually applies.

Under the literalist test, notes are securities more often than

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92. *Id.* at 1139. The court stated that "the purposes of the registration and anti-fraud provisions [of the Securities Acts] differ, thus altering the 'context' to be examined to determine whether the admonition 'unless the context otherwise requires' is to be applied." *Id.* (emphasis added).

The Supreme Court suggested that the introductory phrase applies to the context of the defined words in the statute. "Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the 1933 and the 1934 Acts preface their lists of general definitions with the phrase 'unless the context otherwise requires.'" *SEC v. National Sec., Inc.*, 393 U.S. 453, 466 (1969). One commentator argued that the "context" referred to is the context of the statute itself. "Congress attempted to define critical terms in the statute; it did not delegate its definition-making authority to litigants." Hammett, *supra* note 5, at 39. See also Sonnenschien, *supra* note 62, at 1572.

Another commentator simply stated that "[r]easoning from 'unless the context otherwise requires . . . ' is an exercise in futility." Carter, *Bank Loans and Bank Credit Agreements: Federal Securities Laws Status*, 93 BANKING L.J. 1020, 1027 (1976).

93. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 848-51 (1975).

94. 544 F.2d at 1137.

95. The exceptions are:

the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business.

*Id.* at 1138.

96. *Id.*

under the other two tests. The vagaries of the commercial/investment dichotomy and the risk capital test preclude accurate predictions concerning whether notes are securities. Those tests presume exclusion from the Securities Acts unless the note represents an investment or risk capital. Conversely, the literalist test presumes that the Securities Acts apply to a note unless it falls within one of the *Exchange National Bank* exceptions. If the note does not fit an exception, it is a security, as is any participation therein.<sup>97</sup>

The literalist test possesses advantages that the commercial/investment dichotomy and the risk capital test lack. Because the literalist test expressly considers the purposes of the Securities Acts, it should remain more faithful to the original congressional intent. By including "any note," Congress intended that the Securities Acts have broad application to effectuate their remedial purposes.<sup>98</sup> By restricting definitions of an investment or risk capital, the courts instead have limited the coverage of the Securities Acts. Only the literalist test avoids artificial contraction of the Securities Acts by concentrating on the clear statutory definitions and not basing its decisions upon such nebulous terms as "investment" and "risk." Finally, the literalist test results in more consistent interpretation of the Securities Acts because of its ease of application. The United States District Court for the District of Columbia summed up these advantages of the literalist approach, stating that "the Second Circuit's approach is most consistent with the language of the statute and Congressional intent and is by far the easiest test to apply."<sup>99</sup>

In summary, a note underlying a loan participation agreement

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97. *Commercial Discount Corp. v. Lincoln First Commercial Corp.*, 445 F. Supp. 1263, 1265-68 (S.D.N.Y. 1978).

98. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847-48 (1975); *SEC v. Universal Services Ass'n*, 106 F.2d 232, 237 (7th Cir. 1939), *cert. denied*, 308 U.S. 622 (1940); *SEC v. Crude Oil Corp. of Am.*, 93 F.2d 844, 846-47 (7th Cir. 1937); *SEC v. Wickham*, 12 F. Supp. 245, 247 (D. Minn. 1935).

99. *SEC v. Diversified Indus., Inc.*, 465 F. Supp. 104, 110 (D.D.C. 1979). Some commentators contend that the enumeration of six transactions rebutting the presumption that long-term notes are securities suffers from inflexibility. See, e.g., 30 VAND. L. REV. 110 (1977). See also Coffey, *The Economic Realities of a 'Security': Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367, 369 (1967). Enumeration is less flexible than a balancing of numerous factors, but it allows for greater certainty and predictability. Additionally, as novel types of transactions develop, the courts presumably will alter the list of enumerated transactions to deal with changed circumstances.

may constitute a security under any of the three tests. If the note represents an investment, risk capital, or does not fall under one of the *Exchange National Bank* exceptions, the note satisfies the commercial/investment dichotomy, risk capital test, or literalist test respectively. If the note is a security, any loan participation in that note also is a security.

### INVESTMENT CONTRACTS AS SECURITIES

Loan participation agreements may be securities if either the underlying loan or the loan participation agreement itself is an investment contract. Both statutory definitions of a security include investment contracts,<sup>100</sup> but neither the Securities Acts nor their legislative histories defines an investment contract.<sup>101</sup> In *SEC v. C.M. Joiner Leasing Corp.*,<sup>102</sup> the United States Supreme Court first considered what constituted an investment contract. The Court examined "what character the investment is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."<sup>103</sup>

Three years after *Joiner*, the Supreme Court provided a more specific and less circular definition of an investment contract in *SEC v. W.J. Howey Co.*<sup>104</sup> In *Howey*, the SEC sought an injunction against the sale of allegedly unregistered investment contracts. The W.J. Howey Company owned a citrus grove and sold portions to the public, offering a service contract to each buyer of a part of the grove. The service contract was not mandatory, but the small size of the individual holdings and the buyers' lack of knowledge and equipment precluded most buyers from caring for their trees themselves.<sup>105</sup>

Adopting the construction of "investment contract" in many

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100. For the definition of a security under the 1933 Act, see *supra* note 22. For the definition of a security under the 1934 Act, see *supra* note 23.

101. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946). For the legislative histories of the Securities Acts, see J. ELLENBERGER & E. MAHAR, *LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934* (1973) [hereinafter cited as *LEGISLATIVE HISTORY*].

102. 320 U.S. 344 (1943).

103. *Id.* at 352-53.

104. 328 U.S. 293 (1946).

105. *Id.* at 296.

states' Blue Sky laws,<sup>106</sup> the Court in *Howey* defined an investment contract as "a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."<sup>107</sup> Thus, an investment contract requires four elements: an investment of money, a common enterprise, and profits derived from the efforts of the promoter or a third party. A transaction containing these four elements is an investment contract and thus a security.

### *Elements of the Howey Test*

#### *Investment of Money*

To satisfy the investment requirement of *Howey*, an investor must give up "a specific consideration in return for a separable financial interest with the characteristics of a security."<sup>108</sup> The consideration need not be money,<sup>109</sup> although usually it is. Additionally, the Supreme Court indicated that investment must be the main reason for the transaction; for example, working for a living is not an investment in a pension plan.<sup>110</sup>

The courts have split over how to apply the investment element. One commentator stated that courts often presuppose an investment because "[i]nvestment in the context of the federal securities laws involves nothing more than the turnover of consideration for the expectation of gain."<sup>111</sup> The United States Court of Appeals for

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106. See generally *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 56, 177 N.W. 937, 938 (1920).

107. 328 U.S. at 298-99. The term "investment contract" had been used in state security laws and defined by state courts. Thus, "[b]y including an investment contract within the scope of § 2(1) of the Securities Act, Congress was using a term the meaning of which had been crystallized by . . . prior judicial interpretation." *Id.* at 298.

108. *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 559 (1979).

109. *SEC v. Addison*, 194 F. Supp. 709, 722 (N.D. Tex. 1961) (involving a contribution of labor). Several commentators have suggested that the requirements should be an investment of money's worth. See, e.g., Coffey, *supra* note 99, at 376-413; Long, *Definition of a Security*, 6 ST. MARY'S L.J. 96 (1974); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 161-62 (1971).

110. *International Bhd. of Teamsters v. Daniel*, 439 U.S. at 560. "Looking at the economic realities, it seems clear that an employee is selling his labor primarily to obtain a livelihood, not making an investment." *Id.*

111. Deacon & Prendergast, *Defining a 'Security' After the Forman Decision*, 11 PAC. L.J. 213, 228 n.43 (1980).

the Ninth Circuit, in *Hector v. Wiens*,<sup>112</sup> held that investment "means only that the investor must commit his assets to the enterprise in such a manner as to subject himself to financial loss."<sup>113</sup> Some courts, however, apply the requirement more strictly, adopting the commercial/investment dichotomy<sup>114</sup> and the risk capital test<sup>115</sup> to determine whether a transaction involves an investment for investment contract purposes.

Courts should not apply the investment element too strictly. The Supreme Court in *Howey* held that an investment is a contribution of money with the expectation of receiving profits from the efforts of the promoter.<sup>116</sup> Such a definition indicates that a wide variety of transactions are investments. To give effect to the remedial purposes<sup>117</sup> and broad scope<sup>118</sup> of the Securities Acts, the courts cannot insist upon an overly formalistic definition of an investment.

A bank loan may satisfy the investment element of the *Howey* test depending upon the court's definition of investment.<sup>119</sup> If a court merely requires a transfer of consideration, a bank loan clearly satisfies this requirement. Bank loans also may satisfy the commercial/investment dichotomy test and risk capital test of an investment. If the loan is to promote a new business, to purchase capital assets, or to rejuvenate a failing business the loan is an investment under the commercial/investment dichotomy test and thus satisfies the investment element of *Howey*.<sup>120</sup> A loan also places the bank's funds at a risk of loss under the Ninth Circuit's

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112. 533 F.2d 429 (9th Cir. 1976).

113. *Id.* at 432.

114. *American Fletcher Mort. Co. v. United States Steel Credit Corp.*, 635 F.2d 1247, 1253-55 (7th Cir. 1980), *cert. denied*, 451 U.S. 911 (1981). See also Note, *Bank Loan Participations: the Affirmative Duty to Disclose under SEC Rule 10b-5*, 27 SYRACUSE L. REV. 807 (1976); Note, *Real Estate as Securities: Sales of Residential Sub-division Lots*, 1979 WASH. U.L.Q. 965, 977-81. For a discussion of the commercial/investment dichotomy, see *supra* notes 45-71 and accompanying text.

115. *Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1181-83 (6th Cir.), *cert. denied*, 102 S. Ct. 972 (1981). For a discussion of the risk capital test, see *supra* notes 72-88 and accompanying text.

116. 328 U.S. at 299-300.

117. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975).

118. See *supra* note 98.

119. See Hammett, *supra* note 5. See also *supra* notes 108-18 and accompanying text.

120. See *supra* notes 45-71 and accompanying text.

definition of investment in *Hector v. Wiens*.<sup>121</sup> A bank loan, therefore, often can satisfy the investment requirement of *Howey*.

A participant bank also makes an investment when purchasing a participation interest.<sup>122</sup> The making of a loan and the sale of a participation in that loan are two separate transactions and must not be confused. The loan participation may be an investment even though the underlying loan is not.<sup>123</sup> In fact, loans and loan participations differ in many significant aspects. Because the lead bank has superior access to information concerning the borrower, the party providing the funds, in this case the participant bank, is in an inferior position as to the lead bank, which is the reverse of a normal loan transaction.<sup>124</sup>

The purchase of a loan participation may be an investment, because it is not a loan to either the borrower or the lead bank. The participant bank has no legal rights against the borrower and thus cannot have a debtor-creditor relationship typical of a loan with the borrower.<sup>125</sup> Because the terms of the loan participation agreement limit whatever rights the participant bank may have against the lead bank,<sup>126</sup> the participant bank does not have a debtor-creditor relationship even with the lead bank. The participant bank is not making a loan, and therefore the bank is investing its funds.

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121. 533 F.2d 429, 432 (9th Cir. 1976). See *supra* notes 112 & 113 and accompanying text.

122. *NBI Mort. Inv. Corp. v. Chemical Bank*, [1976-1977 Transfer Binder] *FED. SEC. L. REP.* (CCH) ¶95,632 (S.D.N.Y. 1976).

123. See *United Cal. Bank v. THC Fin. Corp.*, 557 F.2d 1351, 1357 n.8 (9th Cir. 1977); *Robbins v. First Am. Bank*, [1981-1982 Transfer Binder] *FED. SEC. L. REP.* (CCH) ¶98,240 (N.D. Va. 1981); *Commercial Discount Corp. v. Lincoln First Commercial Corp.*, 445 F. Supp. 1263, 1267 (S.D.N.Y. 1978); *Avenue State Bank v. Tourtelot*, 379 F. Supp. 250, 254 (N.D. Ill. 1974). But see *Provident Nat'l Bank v. Frankford Trust Co.*, 468 F. Supp. 448 (E.D. Pa. 1979).

124. Concurring in *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976), Judge Wright stated that "[i]n an investment situation, the issuer has superior access to and control of information material to the investment decision." *Id.* at 1262 (Wright, J., concurring). In a loan participation, the participant banks' information regarding the participation originates with the lead bank. The lead bank therefore has superior access to and control of information.

125. For a discussion of the rights of debtors and creditors, see J. MOORE, W. PHILLIPS & R. D'AGOSTINO, *DEBTORS' AND CREDITORS' RIGHTS* (5th ed. 1979).

126. See *supra* notes 13-16 and accompanying text.

*Common Enterprise*

Courts have adopted two interpretations of the common enterprise requirement.<sup>127</sup> In the "vertical" approach, the relationship between the investor and the promoter is important; one investor and one promoter may satisfy the common enterprise requirement. Under the "horizontal" approach, the court examines the relationship among the investors and requires a pooling of the investors' funds or a pro rata sharing of profits. The horizontal approach thus demands a number of investors for a common enterprise.

The United States Court of Appeals for the Seventh Circuit adopted the horizontal approach in *Milnarik v. M-S Commodities, Inc.*<sup>128</sup> The broker's clients holding a discretionary trading account in commodities futures failed to show commonality because "the success or failure of [the] other contracts had no direct impact on the profitability of plaintiffs' contract."<sup>129</sup> The court stated that *Howey* required joint participation or a pooling of assets because in *Howey* numerous investors participated, the corporation commingled the investors' funds, and the investors expected their return from the operations of the entire citrus grove.<sup>130</sup>

The United States Courts of Appeal for the Fifth and Ninth Circuits expressly rejected the necessity of pooling for a common enterprise and employed the vertical approach. In *SEC v. Glen W. Turner Enterprises, Inc.*,<sup>131</sup> the Ninth Circuit defined a common enterprise as "one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."<sup>132</sup> The Fifth Circuit adopted the Ninth Circuit's definition and held that if the fortunes of the investors are "inextricably tied" to the success of the ven-

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127. See 43 Mo. L. Rev. 779, 783-89 (1978).

128. 457 F.2d 274 (7th Cir.), cert. denied, 409 U.S. 887 (1972).

129. *Id.* at 276.

130. *Id.* at 279. Other cases employing the horizontal approach include *Curran v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 222 (6th Cir. 1980), *aff'd*, 453 U.S. 925 (1982); *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96, 101-02 (7th Cir. 1977); *Sunshine Kitchens v. Alanthus Corp.*, 403 F. Supp. 719, 721-22 (S.D. Fla. 1975); *Arnold v. Bache & Co.*, 377 F. Supp. 61, 64-65 (M.D. Pa. 1973).

131. 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973).

132. *Id.* at 482 n.7. The vertical approach also was used in *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224, 1229 (9th Cir.), cert. denied, 419 U.S. 900 (1974); *Jones v. International Investors Inc.*, 429 F. Supp. 119, 123-24 (N.D. Ga. 1976).

ture, the scheme is a common enterprise.<sup>133</sup> "[T]hat an investor's return is independent of that of other investors in the scheme is not decisive."<sup>134</sup>

Most courts adopt the vertical approach,<sup>135</sup> which represents the better interpretation. Although *Howey* involved numerous investors, the Court did not require pooling, but emphasized instead the promoter's control and management of the enterprise. The promoters did pool the produce for marketing, but each investor received a return based on the harvest from his individual plot.<sup>136</sup> Another reason not to require pooling is that the Securities Acts serve a remedial function, and the Acts must be interpreted broadly to achieve their purpose.<sup>137</sup> If pooling were required, promoters could evade the Securities Acts merely by separating each individual's account from the others.

A court must consider the economic realities of a transaction and disregard form for substance.<sup>138</sup> An arrangement between one promoter and one investor may present all the dangers that the Securities Acts seek to prevent.<sup>139</sup> Instead of employing a mechanical pooling requirement, courts should examine the vertical relationship between an investor and the promoter to determine if the venture is a common enterprise.

The loan arrangement between the bank and the borrower may be a common enterprise under the vertical approach if the financial interests of the parties are inextricably tied.<sup>140</sup> Each party

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133. *Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478-79 (5th Cir. 1974).

134. 497 F.2d at 479.

135. See 43 Mo. L. Rev. 779, 783 (1978). Other cases adopting the vertical approach include *Hector v. Wiens*, 533 F.2d 429, 433 (9th Cir. 1976); *Continental Mktg. Corp. v. SEC*, 387 F.2d 466 (10th Cir. 1967), cert. denied, 391 U.S. 905 (1968); *SEC v. Brigadoon Scotch Distrib.*, 388 F. Supp. 1288, 1291-92 (S.D.N.Y. 1975); *Maheu v. Reynolds & Co.*, 282 F. Supp. 423, 429 (S.D.N.Y. 1967). Professor Louis Loss wrote that "proof of some sort of pooling arrangement among investors . . . helps, but it is not essential." 1 L. Loss, *SECURITIES REGULATIONS* 489 (2d ed. 1961).

136. *SEC v. W.J. Howey Co.*, 328 U.S. at 296.

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

138. *United Hous. Found., Inc. v. Forman*, 421 U.S. at 848 (quoting *Tcherepnin v. Knight*, 389 U.S. at 336).

139. For a discussion of the intent of the Securities Acts, see *LEGISLATIVE HISTORY*, *supra* note 101. See also *infra* notes 166-68 and accompanying text.

140. See *supra* notes 131-35 and accompanying text.

shares a common profit motive and desires that the loan be repaid. The borrower's use of the money actually may provide the funds with which he repays the loan. The success of the borrower flows to the bank in the repayment of the loan.

If a court applied the horizontal approach, a bank loan would be a common enterprise only if the loan involved more than one bank. Under this approach, a loan from one bank to a borrower is never a common enterprise. The vertical approach represents the better interpretation of *Howey* because it carries out the purpose of the Securities Acts.<sup>141</sup> A bank loan therefore generally qualifies as a common enterprise under the vertical approach.

Loan participation agreements also constitute common enterprises between the participant bank and the lead bank. The participant bank's fortunes are tied inextricably to the success of the loan participation as required under the vertical interpretation. All participant banks look to the lead bank for their profits. If the loan participation fails, the participant banks lose their money. Loan participation agreements are common enterprises even under the horizontal approach, because the lead bank usually commingles the funds provided by the participant banks, and the participant banks receive pro rata shares of the principal and interest.<sup>142</sup>

### *Profits*

The Supreme Court defined profits in an investment contract as "either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds . . . ."<sup>143</sup> Additionally, variable returns related to the success of a business are profits.<sup>144</sup> The Supreme Court's definition of profits includes interest as a "participation in earnings resulting from the use of investors' funds."<sup>145</sup> This definition, however, has been interpreted differently by various courts.<sup>146</sup>

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141. See *supra* notes 131-39 and accompanying text.

142. See Note, *supra* note 1, at 179-80.

143. *United Hous. Found., Inc. v. Forman*, 421 U.S. at 852.

144. See *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967); *SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65 (1959); *Manchester Bank v. Connecticut Bank & Trust Co.*, 497 F. Supp. 1304, 1313 (D.N.H. 1980).

145. 421 U.S. at 852.

146. The courts are divided on the issue of whether interest constitutes profits for invest-

An examination of the economic realities of commercial banking indicates that interest should be considered profits for investment contracts.<sup>147</sup> Banks are not charitable institutions; they enter into a transaction to make a profit in the form of interest. That these profits are fixed by a rate of interest should not alter their status as profits. An interest rate merely places a limit upon how much profit the bank can receive. "[A] ceiling on the expected return does not go to the question of whether profit was expected; rather, it goes to the question of how much profit was expected."<sup>148</sup> The United States District Court for the Eastern District of Pennsylvania, in *Provident National Bank v. Frankford Trust Co.*,<sup>149</sup> stated that "profits in the form of a fixed return are no less profits as envisioned by the *Howey* test."<sup>150</sup> The fairly secure nature of interest compared with the uncertainty of a varied return based on a business's success is irrelevant to a discussion of the existence, as opposed to the amount, of profits.<sup>151</sup>

Interest payments by the borrower to the lending bank in the case of a bank loan and by the lead bank to the participant banks in a loan participation agreement therefore satisfy the profit requirement. Such a result recognizes economic realities, because a bank would not loan the money or join the loan participation if it did not expect to earn a profit.<sup>152</sup>

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ment contracts. A slight majority of courts hold that interest does not constitute profits. Cases holding that interest constitutes profits include *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224, 1229 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974); *Los Angeles Trust Deed & Mort. Exch. v. SEC*, 285 F.2d 162, 168-72 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961). *But see* *United Am. Bank v. Gunter*, 620 F.2d 1109, 1117-18 (5th Cir. 1980); *Canadian Imperial Bank of Commerce Trust Co. v. Fingland*, 615 F.2d 465 (7th Cir. 1980); *FBS Fin., Inc. v. CleveTrust Realty Investors* [1978 Transfer Binder], *FED SEC. L. REP.* (CCH) ¶96,341 (N.D. Ohio 1977).

147. See Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 *HASTINGS L.J.* 219, 237-38 (1974); Note, *supra* note 6, at 814; Comment, *supra* note 11, at 529-31.

148. Note, *supra* note 1, at 186. Some commentators merely assume that interest payments are profits. "[P]articipating banks undeniably join the syndication for profit." Note, *supra* note 21, at 906.

149. 468 F. Supp. 448 (E.D. Pa. 1979).

150. *Id.* at 455.

151. 328 U.S. at 301. The Supreme Court stated that "it is immaterial whether the enterprise is speculative or non-speculative." *Id.*

152. One commentator stated that "the profit element follows the implied fact that a reasonable expectation of profit accompanies the decision of a bank to join the lending syn-

*Solely from the Efforts of Others*

The requirement that an investor in a true security arrangement derive profits from the efforts of others separates investors who need the protection of the Securities Acts from those who can protect themselves through their control of the enterprise. Courts in early cases strictly construed the word "solely" and held that if the investor participated at all, beyond providing funds, the scheme was not an investment contract. Such a result, however, was unduly harsh and presented promoters with an easy means to avoid the sanctions of the Securities Acts.<sup>153</sup>

Emphasizing the remedial nature of the Securities Acts and the Supreme Court's admonition that the definition of a security should be flexible, the United States Court of Appeals for the Ninth Circuit expressly rejected a strict interpretation of the word "solely." The test instead was "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."<sup>154</sup> The Supreme Court, in *United Housing Foundation, Inc. v. Forman*,<sup>155</sup> discussed this interpretation but refused to express a view because that precise issue was not raised.<sup>156</sup> In considering the *Howey* test, however, the Court left out the word "solely" and restated this requirement as profits "to be derived from the entrepreneurial or managerial efforts of others."<sup>157</sup> The

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dicare." Comment, *supra* note 11, at 529.

153. See generally Comment, *What is a Security? Howey, Turner Enterprises and Franchise Agreements*, 22 U. KAN. L. REV. 55 (1973).

154. SEC v. Glen W. Turner Enter., 474 F.2d at 482. The Fifth Circuit also adopted this interpretation, stating that "[a] literal application of the *Howey* test would frustrate the remedial purposes of the Acts." SEC v. Koscot Interplanetary, Inc., 497 F.2d at 480. *Accord* Jones v. International Investors Inc., 429 F. Supp. 119, 123-25 (N.D. Ga. 1976); NBI Mortgage Inv. Corp. v. Chemical Bank [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶95,632 (S.D.N.Y. 1976). The SEC followed this interpretation in SEC Securities Act Release No. 5211: "It must be emphasized that the assignment of nominal or limited responsibilities to the participant does not negative the existence of an investment contract . . ." SEC Securities Act Release No. 5211 (Nov. 30, 1971), [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶78,446.

155. 421 U.S. 837 (1975).

156. *Id.* at 852 n.16.

157. *Id.* at 852. The "others" need not be the promoter or someone controlled by him. Continental Mfg. Corp. v. SEC, 387 F.2d 466, 470-71 (10th Cir. 1967), *cert. denied*, 391 U.S. 905 (1968).

critical factor, then, is the nature of the investor's participation. If the investor makes substantial efforts, he cannot satisfy this requirement.<sup>158</sup> Investors who participate in a substantial way can protect themselves through their control over the transaction and thus do not need the protection of the Securities Acts.

The degree of the lending bank's participation in the handling and use of a loan is critical to the "efforts of others" requirement.<sup>159</sup> If the bank merely loans the money and permits the borrower to use it at his discretion, the bank receives profits from the efforts of others. Generally, however, banks exercise greater control over the use of their funds. Provisions in the loan agreement between the bank and the borrower may require bank approval for certain transactions, the placement of a member of bank management on the borrower's board of directors, or even bank intervention in the borrower's business upon the occurrence of certain specified events.<sup>160</sup> Under these circumstances, a bank loan would not satisfy the "efforts of others" element of the *Howey* test.

In a loan participation, the lead bank is more than a conduit of funds from the borrower to the participant banks, because the lead bank structures the loan and promotes the loan participation. The

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158. For cases in which the investor's participation prevented the scheme involved from being an investment contract, see, e.g., *Chapman v. Rudd Paint & Varnish Co.*, 409 F.2d 635, 641 (9th Cir. 1969); *Wieboldt v. Metz*, 355 F. Supp. 255, 260-61 (S.D.N.Y. 1973).

The Supreme Court stated that the *Howey* test "in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security." *United Hous. Found., Inc. v. Forman*, 421 U.S. at 852. This statement caused some commentators to contend that the *Howey* test "is to be universally applicable to defining securities." Deacon & Prendergast, *supra* note 111, at 214.

Many courts, however, have rejected the universal applicability of *Howey*. The United States Court of Appeals for the Fifth Circuit stated that the Supreme Court "has never suggested that the [*Howey*] test is to be invoked ritualistically whenever the existence of a security is at issue. Instead, the Court has applied the *Howey* test when considerations pertinent to an investment contract applied to the instrument in question." *Meason v. Bank of Miami*, 652 F.2d 542, 549 (5th Cir. 1981), *cert. denied*, 102 S. Ct. 1428 (1982). Various courts apply other tests when considering securities in a context outside investment contracts. See, e.g., *Lincoln Nat'l Bank v. Herber*, 604 F.2d 1038, 1042-45 (7th Cir. 1979) (applying the commercial/investment dichotomy); *United Cal. Bank v. THC Fin. Corp.*, 557 F.2d 1351, 1358-59 (9th Cir. 1977) (employing the risk capital test).

159. *Provident Nat'l Bank v. Frankford Trust Co.*, 468 F. Supp. 448, 455 (E.D. Pa. 1979).

160. In *Parsons Steel, Inc. v. First Alabama Bank*, 679 F.2d 242 (11th Cir. 1982), for example, the bank conditioned credit to a corporation on a change in the corporation's management and ownership. *Id.* at 244.

participant banks generally have no voice in the terms negotiated by the lead bank with the borrower and often must rely exclusively on the lead bank's information as to the credit-worthiness of the borrower and the soundness of the loan participation. The decision whether to participate, therefore, may depend totally upon the efforts of the lead bank.<sup>161</sup>

The reliance of the participant banks upon the lead bank continues after the participant bank joins the loan participation. The lead bank manages and administers the loan. The participant banks have no relationship with the borrower and must rely upon the lead bank for performance. The loan participation agreement, however, may give the participant banks a larger role than merely receiving payments from the lead bank. Participant banks possessing rights or performing tasks essential to the success of the loan participation do not satisfy the "efforts of others" requirement. The allocation of control over the loan participation agreement therefore controls whether the agreement is an investment contract.

In *NBI Mortgage Investment Corp. v. Chemical Bank*,<sup>162</sup> the United States District Court for the Southern District of New York considered whether a participation in a loan for building construction was a security. The court rejected Chemical Bank's argument that the loan participation was the same as the underlying, admittedly commercial loan: "This overlooks the distinction between self-effort and the efforts of others."<sup>163</sup> The court held that loan participation agreements may satisfy the first three elements

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161. See *supra* notes 6-21 and accompanying text.

162. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶95,632 (S.D.N.Y. 1976) (*NBI I*). In *NBI I*, the court denied defendant Chemical Bank's motion for partial summary judgment to dismiss NBI's claim alleging violations of the Securities Acts' antifraud provisions. The court noted that pretrial discovery was incomplete. *Id.* at 90,147.

Less than one year after *NBI I*, the court granted Chemical Bank's motion for summary judgment [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶96,066 (S.D.N.Y. 1977) (*NBI II*). The court based its dismissal on the plaintiff's valid disclaimer of reliance contained in the agreement. ¶96,066 at 91,801.

Numerous cases have held that a loan participation agreement "was, or could be a 'security.'" See, e.g., *United Cal. Bank v. THC Fin. Corp.*, 557 F.2d 1351 (9th Cir. 1977); *Commercial Discount Corp. v. Lincoln First Commercial Corp.*, 445 F. Supp. 1263 (S.D.N.Y. 1978); *Crowell v. Pittsburgh & Lake Erie R.R.*, 373 F. Supp. 1303 (E.D. Pa. 1974).

163. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶95,632 at 90,147 (S.D.N.Y. 1976).

of the *Howey* test,<sup>164</sup> but that the allocation of control over the loan participation varies in every case. Allocation of control between the lead bank and the participant banks is the key issue.<sup>165</sup> In *NBI Mortgage*, the lead bank alone set up and managed the loan participation, which therefore was an investment contract.

Thus, both bank loans and loan participation agreements may be investment contracts under the *Howey* test. Loan participation agreements, however, are more likely to be investment contracts than are bank loans, because lending banks generally possess more control over the use of their funds than participant banks have over the loan participation. Bank loans often do not satisfy the "efforts of others" requirement; nevertheless, if the bank loan is a security, any participation in that loan also is a security.

In summary, loan participation agreements may constitute securities under the Securities Acts. The underlying note may satisfy any of the three court-devised tests to determine whether notes are securities. Alternatively, the bank loan or the loan participation agreement itself may be an investment contract under the *Howey* test. If a loan participation agreement is a security, the banks then must comply with the Securities Acts.

#### IMPLICATIONS OF CHARACTERIZING LOAN PARTICIPATION AGREEMENTS AS SECURITIES

Considering loan participation agreements as securities serves the purposes behind the Securities Acts. The Supreme Court stated that "[t]he focus of the Acts is on the capital market of the enterprise system."<sup>166</sup> Loan participation agreements are one vehi-

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164. *Id.* These elements are an investment of money, in a common enterprise, expecting profits.

165. *Id.* at 90,148. See also 5 BANKING LAW § 102.06 (1981).

166. *United House. Found., Inc. v. Forman*, 421 U.S. at 849. The Senate Committee on Banking and Currency stated:

The aim [of the 1933 Act] is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investors; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by questionable securities offered to the public through crooked promotion . . . .

S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933), quoted in *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479 n.9 (5th Cir. 1974). The Ninth Circuit stated that the purpose of the 1933

cle for raising capital. Another purpose of the Securities Acts is the protection of investors.<sup>167</sup> In many ways, banks invest through loan participation agreements,<sup>168</sup> but the common law does not provide adequate protection to a defrauded participant bank.<sup>169</sup> The Securities Acts include stringent antifraud provisions without which fraudulent lead banks may escape liability. Because loan participation agreements present dangers that the Securities Acts were enacted to prevent, namely disruption of capital markets and fraud upon investors, application of the Acts to these agreements furthers the purposes of the Acts.

Under the Securities Acts, issuers of securities generally must register securities with the Securities and Exchange Commission.<sup>170</sup> Most loan participation agreements should be exempt from the registration requirement under the private placement exemption.<sup>171</sup> If the lead bank and participant banks are in the same state, the intrastate exemption from registration may apply.<sup>172</sup> Loan participation agreements therefore usually can avoid the added cost and

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Act was to "protect the American public from speculative or fraudulent schemes of promoters." SEC v. Glen W. Turner Enter., 474 F.2d at 481.

167. *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 800 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973).

168. *See supra* notes 45-71 & 108-18 and accompanying text.

169. *See supra* note 5.

170. For the registration requirements, see Securities Act of 1933, § 5, 15 U.S.C. § 77e (1976), and Securities Exchange Act of 1934, § 12, 15 U.S.C. § 78l (1976).

171. Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2) (1976) exempts from registration "transactions by an issuer not involving any public offering." *Id.* The SEC interpreted the exemption in Regulation D. 47 Fed. Reg. 11,251, 11,262-66 (1982) (to be codified at 17 C.F.R. §§ 230.501-506). As an accredited investor, as defined in 501(e) of Regulation D, a participant bank satisfies the basic requirements for offerees. This exemption is limited to sales involving no more than 35 purchasers. *Id.* at 11,266 (to be codified at 17 C.F.R. § 230.506(b)(2)(i)). Loan participation agreements generally involve less than 35 participant banks. For a discussion of Regulation D and the 35 purchaser limitation, see Note, *Regulation D: Coherent Exemptions for Small Businesses Under the Securities Act of 1933*, 24 WM. & MARY L. REV. 121 (1982).

172. Securities Act of 1933, § 3(a)(11), 15 U.S.C. § 77c(11) (1976). "Any security which is part of an issue 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." *Id.* Another possible exemption from registration for loan participation agreements is § 3(a)(2) of the 1933 Act, which exempts "any security issued or guaranteed by any bank." 15 U.S.C. § 77(a)(2) (Supp. 1980). That exemption, however, may be limited to the bank's own securities. *See* 1 L. LOSS, SECURITIES REGULATION 564-65 (2d ed. 1961).

burden of registration.

Although exempt from the registration requirements of the Securities Acts, loan participation agreements still must comply with the Acts' antifraud provisions.<sup>173</sup> These sections impose a duty of disclosure when securities are offered or when parties trade on inside information. The lead bank first must disclose information sufficient for prospective participant banks to decide intelligently whether to participate. Such information includes the financial status of the borrower, his credit history, any indications of future trends in the borrower's business and in the industry as a whole, and information concerning the lead bank's managerial ability.<sup>174</sup> The lead bank also may have to disclose any possible conflicts of interest, including any debts that the borrower already owes to the lead bank.<sup>175</sup>

A problem for the lead bank may arise under the disclosure of inside information requirement.<sup>176</sup> The borrower may want some information to remain confidential. The lead bank's failure to disclose such information could cause liability under Rule 10b-5, which requires that a party with inside information either disclose the information or refrain from trading in any transaction to which the information is material.<sup>177</sup> To avoid potential liability,<sup>178</sup> a lead bank should prepare a complete placement memorandum and perhaps allow prospective participants access to its files.<sup>179</sup>

Although potential liability under Rule 10b-5 may increase the costs of loan participation agreements, banks will continue to use participations because of the magnitude of current financial demands.<sup>180</sup> A borrower would not want to establish numerous loans with various banks, each with different terms. Additionally, a bank

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173. See *supra* note 25 and accompanying text.

174. See Note, *supra* note 6, at 825-26, 828.

175. For other examples of possible conflicts of interest, see *id.* at 826-27.

176. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (imposing a duty either to disclose inside information or refrain from trading).

177. *Id.*

178. A lead bank may structure the loan participation agreement so that it is not a security; thus, Rule 10b-5 will not apply.

179. See Note, *supra* note 6, at 829-32 for possible means by which lead banks may avoid liability under the Securities Acts.

180. Loan participations in 1975 totaled \$21.5 billion worldwide. Note, *supra* note 1, at 169 n.28.

would prefer that its customers not deal with other banks directly, which would occur if the lead bank refused to organize a loan participation. Finally, loan participation agreements are profitable for both lead banks and participant banks.<sup>181</sup>

In arranging a loan participation, lead banks may take several steps to avoid liability.<sup>182</sup> First, the lead bank can attempt to structure the loan participation agreement as a loan and not a security. If the participant banks have meaningful managerial control, the loan participation agreement does not satisfy the "efforts of others" requirement for investment contracts. The lead bank also may attempt to avoid loan participations in transactions in which the underlying note may be a security.<sup>183</sup> Another method to avoid liability under Rule 10b-5 would be to adequately disclose all material facts, particularly through the placement memorandum sent to prospective participant banks. If the lead bank does not desire to disclose facts in writing, it can release the information in other ways such as accompanying representatives of the participant banks in visits to the borrower's plants and facilities.<sup>184</sup>

The Proposed American Law Institute Federal Securities Code may provide greater certainty regarding loan participation agreements.<sup>185</sup> In section 202(150)(A), the Code defines a security much like the Securities Acts.<sup>186</sup> The Code also lists exclusions from the

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181. See *supra* notes 6-21 and accompanying text. A lead bank cannot avoid securities considerations by organizing a loan syndication because the latter also may be a security. See Note, *supra* note 7; Note, *supra* note 21.

182. See *supra* note 179.

183. See *supra* notes 32-99 and accompanying text.

184. See Thuleen, *supra* note 6, at 14. The lead bank should encourage the participant banks to make their own investigations.

185. For the status of the proposed code, see Wall Street J., Oct. 8, 1981, at 31, col. 2.

186. FEDERAL SECURITIES CODE § 202(150) (A) (Proposed Draft 1980). A security is: a bond, debenture, note, evidence of indebtedness, share in a company. (whether or not transferable or denominated "stock"), preorganization certificate or subscription, investment contract, certificate of interest or participation in a profit-sharing agreement, collateral trust certificate, equipment trust certificate (including a conditional sale contract or similar interest or instrument serving the same purpose), voting trust certificate, certificate of deposit for a security, or fractional undivided interest in oil, gas, or other mineral rights, or, in general, an interest or instrument commonly considered to be a "security," or a certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or buy or sell, any of the foregoing.

definition in section 202(150)(B),<sup>187</sup> including a note on evidence of indebtedness issued in a primarily mercantile or consumer transaction not involving a distribution.<sup>188</sup> The Securities and Exchange Commission proposed to amend section 202(150)(B) so that it "does not exclude a participation in any of the items excluded under it."<sup>189</sup> The amendment "does not mean that every participation in a primarily mercantile or consumer note . . . is a security. The participation simply is not *excluded*. The participation is a security if it is an investment contract or comes within another of the § 202(150)(A) [definition of security] phrases."<sup>190</sup>

The Code's specific mention of loan participations draws attention to their special attributes and emphasizes their potential characterization as securities, even if the participation involves a consumer or mercantile transaction. Additionally, the proposed amendment requires a court to examine the underlying transaction and the loan participation agreement separately and not to confuse the two. The Code as amended, therefore, would provide greater direction to courts grappling with loan participation characterization.

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*Id.*

187. *Id.* § 202 (150)(B). A security does not include:

(i) currency; (ii) a check (whether or not certified), draft, bill of exchange or bank letter of credit; (iii) (except for purposes of part XV) a note or evidence of indebtedness issued in a primarily mercantile or consumer, rather than investment, transaction not involving a distribution (see also sections 202(25) and 302(11)); (iv) an interest in a deposit account with a bank (but not a participation in such interests); (v) (except for purposes of parts XII and XIV) a bank certificate of deposit that ranks on a parity in liquidation with an interest in a deposit account with the bank; (vi) an insurance policy (including an endowment policy) issued by a company within section 202 (76)(A); (vii) an annuity contract (including an optional annuity contract) under which a company within section 202(76)(A) promises to pay one or more sums of money that are fixed or vary in accordance with a cost-of-living index or on any other basis specified by rule; (viii) a commodity contract (whether for present or future delivery) or warrant or right to buy or sell such a contract; or (ix) the interest of a mini-account client in a mini-account under advisement if section 814(c) is effective; but section 202(150)(B) does not exclude a participation in any of the foregoing.

*Id.*

188. *Id.*

189. *Id.*

190. *Id.*

## CONCLUSION

Loan participation agreements often are securities under the Securities Acts. The note underlying the loan participation may satisfy any of the three tests determining whether notes are securities.<sup>191</sup> Bank loans are investment contracts if they qualify under the *Howey* test.<sup>192</sup> If the underlying note or loan is a security, the loan participation agreement also is a security. The loan participation agreement itself may be an investment contract even though the underlying note is not a security. Loan participation agreements generally satisfy the first three elements of the *Howey* test. The structure of the loan participation, in allocating control between the lead bank and the participant banks, determines whether the loan participation agreement also satisfies the fourth element of the *Howey* test and is thus a security.<sup>193</sup>

The widely divergent judicial tests applied to notes and investment contracts have hampered the classification of loan participation agreements. Legislative clarification would be welcome. Indeed, the proposed Federal Securities Code provides greater certainty regarding loan participation agreements. Until the Code or similar legislation becomes a reality, however, courts will apply one of many tests on a case-by-case basis, resulting in continued confusion and uncertainty for banks and investors.

J. THOMAS COOKSON

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191. See *supra* notes 32-99 and accompanying text.

192. See *supra* notes 100-52 and accompanying text.

193. See *supra* notes 153-65 and accompanying text.